

Introduction to Transfer Pricing Principles, Methods and Recent Developments

Sébastien Gonnet, NERA Economic Consulting

Hong-Kong, The Hong Kong Bankers Club, 28th September 2011



Objectives of the Presentation

- **Provide an overview of the principles governing transfer pricing worldwide, discuss recent developments in developed (OECD) countries and in the BRICS, and describe transfer pricing / valuation methods**





Contents

- **What is Transfer Pricing?**
- **The Arm's Length Principle**
- **OECD Developments and Recent Trends**
- **Transfer Pricing and Valuation Methods**
- **Transfer Pricing Challenges in the BRICS**





What is Transfer Pricing?





What is "Transfer Pricing"?!

Thursday 15 September 2011
A6 OPINION

Big American firms play dirty shell games

Paul Eggerman

I LOVE America, and have proudly invested in America. I have invested by building successful businesses employing thousands of American workers. And I have invested in our country by paying taxes.

But our nation loses US\$100 billion a year to tax dodging by some of our largest corporations and wealthiest people. That's a trillion dollar hole in our national treasury over the next decade unless we act now to plug it.

Tax dodging companies are disinvesting in our country — not investing in it. Many US multinational companies use a gimmick called "transfer pricing" — shifting patents to their offshore subsidiaries, for example — in order to pretend they've earned their profits in a tax haven like the Cayman Islands, Bermuda or Luxembourg, even though their operations there may be little more than a mail box. What they're really doing is transferring their US profits offshore and transferring their tax responsibilities to the rest of us.

In this global version of a shell game,

company subsidiaries, the US parent company reports to the IRS that they've made almost no profits, or even lost money on their US operations. These companies are passing the buck to other taxpayers and robbing our national treasury of funds we need.

It sickens me that businesses like mine responsibly paid taxes at the rate of 35 percent on millions of dollars in profits while companies like General Electric would pay zero percent on billions of dollars in profits.

I have been fortunate to live the American Dream. I know my success is due to many factors. I know, for example, as a software entrepreneur, that I would have had no business at all without the government assistance I received for my college education, or the government research that led to the Internet.

Tax dodging

It's obscene that computer and internet companies like Google, Microsoft, Apple and Cisco are part of a coalition clamoring for a tax holiday to "repair" profits they shifted to tax havens to avoid US taxes.

It's obscene that so many members of Congress are willing to legislate austerity for American workers, small businesses and retirees while leaving the door open for big corporations to dodge taxes through tax havens.

We all benefit from public services, infrastructure and research paid for by tax dollars. Instead of reducing our debt by cutting vital services, we need to close two big tax deficits — the tax haven deficit and the deficit from the Bush tax cuts for the affluent. Each is worth a trillion dollars over the next decade.

The Stop Tax Havens Abuse Act introduced recently in Congress by Democratic Senator Carl Levin of Minnesota and Democratic Representative Lloyd Doggett of Texas would close the loopholes that reward those who shunt in America and dodge taxes to unfairly boost their corporate treasuries. It should be a no-brainer solution in deficit reduction.

It is simply outrageous that we would ask unemployed and disabled Americans and Medicare and Social Security recipients to sacrifice more while continuing to shower tax savings on multimillionaires and billionaires who have a larger share of the nation's income than any time since the 1920s.

It's time for Congress to plug the loopholes that allow our largest corporations to avoid billions of dollars in taxes.

After all, American corporations and wealthy individuals should be proud to support our country and invest in its future.

Paul Eggerman is co-founder of the technology company eSolutions. Copyright American Political Technology company allocation. Copyright American Political Technology company allocation.

Shanghai Daily

www.shanghaidaily.com/opinion

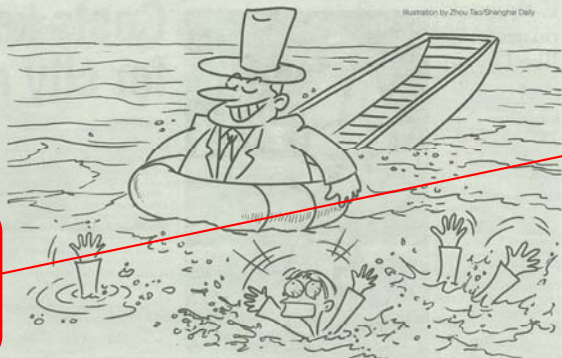


Illustration by Zhou Tao/Shanghai Daily

US taxpayers bankroll elephant in the room

Nassim Nicholas Taleb and Mark Spitznagel

FOR the American economy, and for many other developed economies, the elephant in the room is the amount of money paid to bankers over the last five years.

In the United States, the sum stands at an astounding US\$2.2 trillion for banks that have filings with the US Securities and Exchange Commission.

Extrapolating over the coming decade, the numbers would approach US\$5 trillion, an amount vastly larger than what both President Barack Obama's administration and his Republican opponents seem willing to cut from further government deficits.

That US\$5 trillion dollars is not money invested in building roads, schools, and other long-term projects, but is directly transferred from the American economy to the personal accounts of bank executives and employees.

Such transfers represent as causing a tax on everyone else as one can imagine.

It feels quite inequitable that bankers, having helped cause today's financial and economic troubles, are the only class that is not suffering from them — and in many cases are actually benefiting.

Mainstream megabanks are puzzling in many respects. It is no secret that they have operated so far as large sophisticated compensation schemes, making probabilities of low-risk, high-impact "Black Swan" events and benefiting from the free backdrop of implicit public guarantees.

Excessive leverage, rather than skills, can be seen as the source of their resulting profits, which then flow disproportionately to employees, and of their sometimes massive losses, which are borne by shareholders and taxpayers.

In other words, banks take risks, get paid for the upside, and then transfer the downside to shareholders, taxpayers, and even retirees. In order to rescue the banking system, the Federal Reserve, for example, put interest rates at artificially low levels, as was disclosed recently, it also has provided secret

loans of US\$1.2 trillion to banks. The main effect so far has been to help bankers generate bonuses (rather than attract borrowers) by hiding exposures.

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the right risk-sharing, and therefore the right corporate governance.

One may wonder: If investment managers and their clients don't receive high returns on bank stocks, as they would if they were profiting from bankers' externalization of risk onto taxpayers, why do they hold them at all? The answer is the so-called "beta", banks represent a large share of the S&P 500, and managers need to be invested in them.

We don't believe that regulation is a panacea for this state of affairs. The largest, most sophisticated banks have become expert at remaining one step ahead of regulators — constantly creating complex financial products and derivatives that skirt the letter of the rules.

In these circumstances, more complicated regulations merely mean more billable hours for lawyers, more income for regulators switching sides, and more profits for derivatives traders.

Investment managers have a moral and professional responsibility to play their role in bringing some discipline into the banking system. Their first step should be to separate banks according to their compensation criteria. Investors have used ethical grounds in the past — excluding, say, tobacco companies abetting apartheid in South Africa — and have been successful in generating pressure on the underlying stocks.

Investing in banks constitutes a double breach — ethical and professional.

Investors, and the rest of us, would be much better off if these funds flowed to more productive companies, perhaps with an amount equivalent to what would be transferred to bankers' bonuses redirected to well-managed charities.

Nassim Nicholas Taleb is professor of risk engineering at MIT and the author of "The Black Swan". Mark Spitznagel is a hedge fund manager. The views expressed here are those of the authors and do not represent the views of their employers. Copyright Project Syndicate, 2011. www.project-syndicate.org

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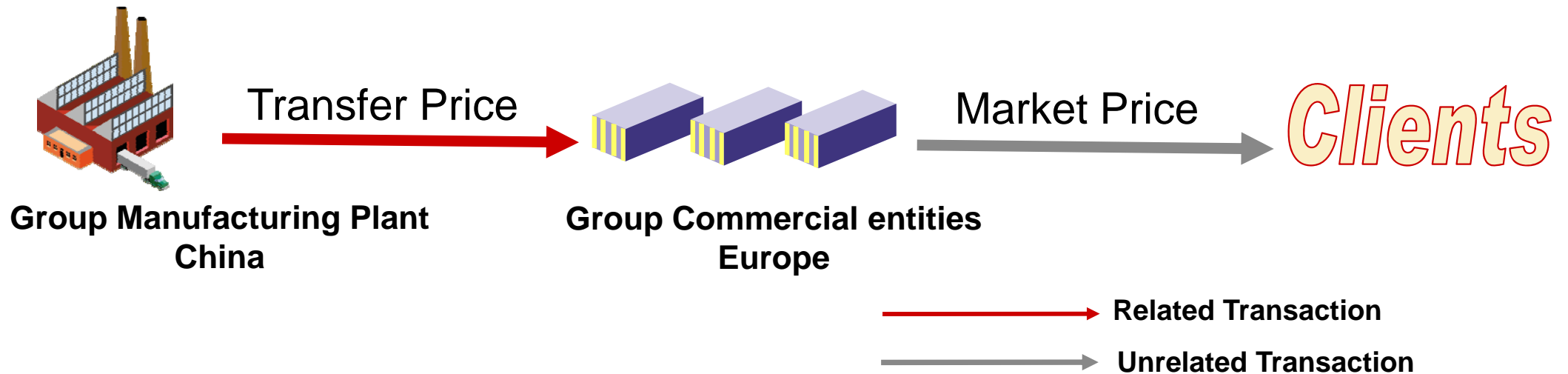
Shanghai Daily, 15 September 2011





Case Study 1 - Producing in China

- Overview of transfer pricing flows





Case study 1 - Producing in China

- What is the “right” (arm’s length) Transfer Price?

Plant P&L

| |
|---------------------------|
| Volumes |
| Transfer Price (per unit) |
| Revenues |
| Cost of Goods |
| OPEX – variable |
| OPEX - fixed |
| Operating profit |
| Return on total costs |

Budget / normal course of business

| |
|--------------|
| 10000 |
| 0.011 |
| 110 |
| 35 |
| 40 |
| 25 |
| 10 |
| 10% |

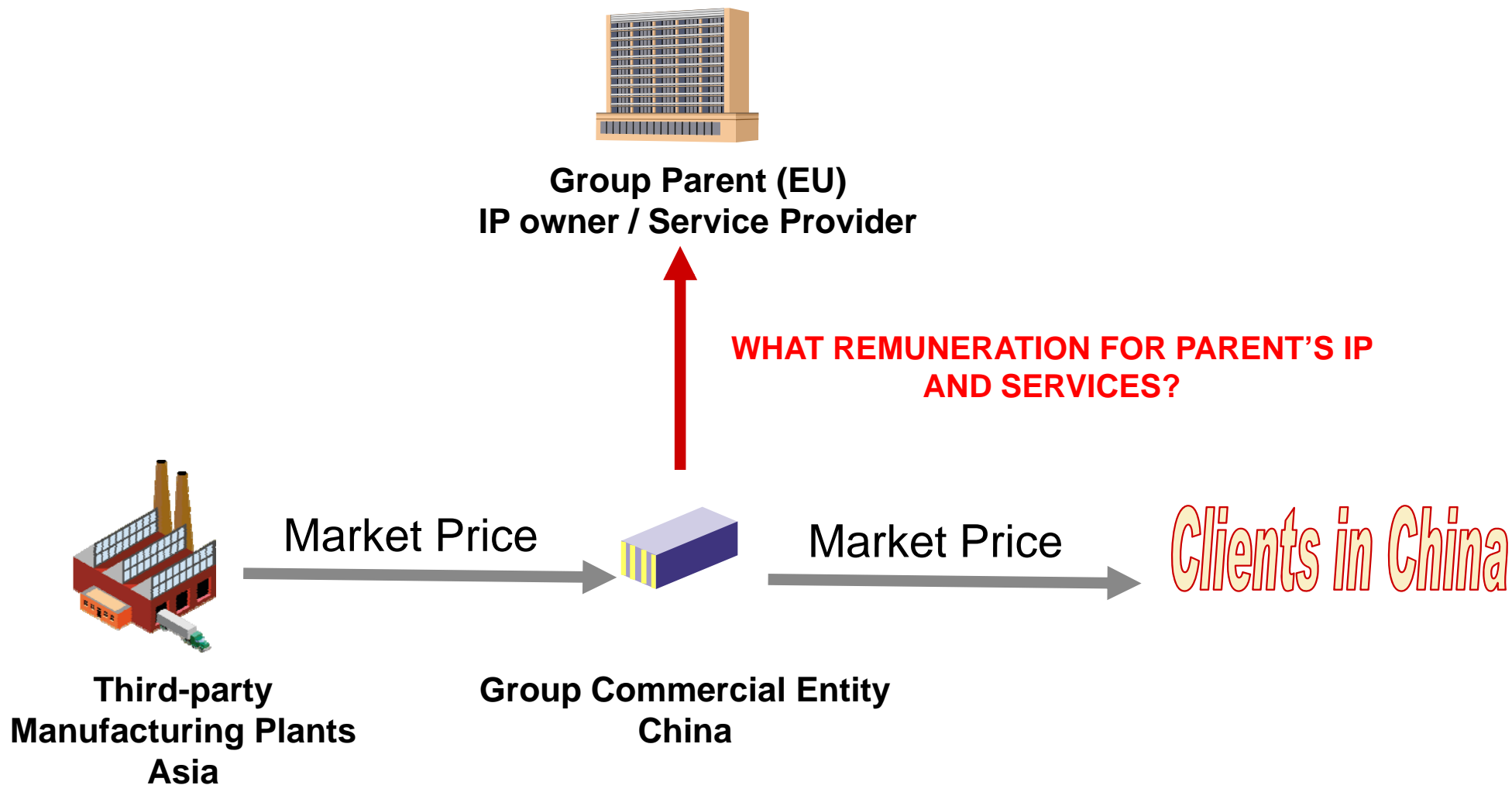
Following year / sudden drop in demand

| | |
|--------------|--------------|
| 6000 | |
| 0.011 | 0.013 |
| 66 | 77 |
| 21 | 21 |
| 24 | 24 |
| 25 | 25 |
| (4) | 7 |
| -5.7% | 10% |





Case Study 2 - Selling in China





The Arm's Length Principle





The Arm's Length Principle

- **What is transfer pricing?**

- Transfer pricing refers to cross-border intra-group transactions
 - Products
 - Services
 - Intangibles
 - Financial transactions

- **What does it do for your company?**

- It drives the allocation of profit inside your company
 - Allocation between business units, divisions, countries...
- And ultimately it is seen as the major controversy issue with the tax authorities





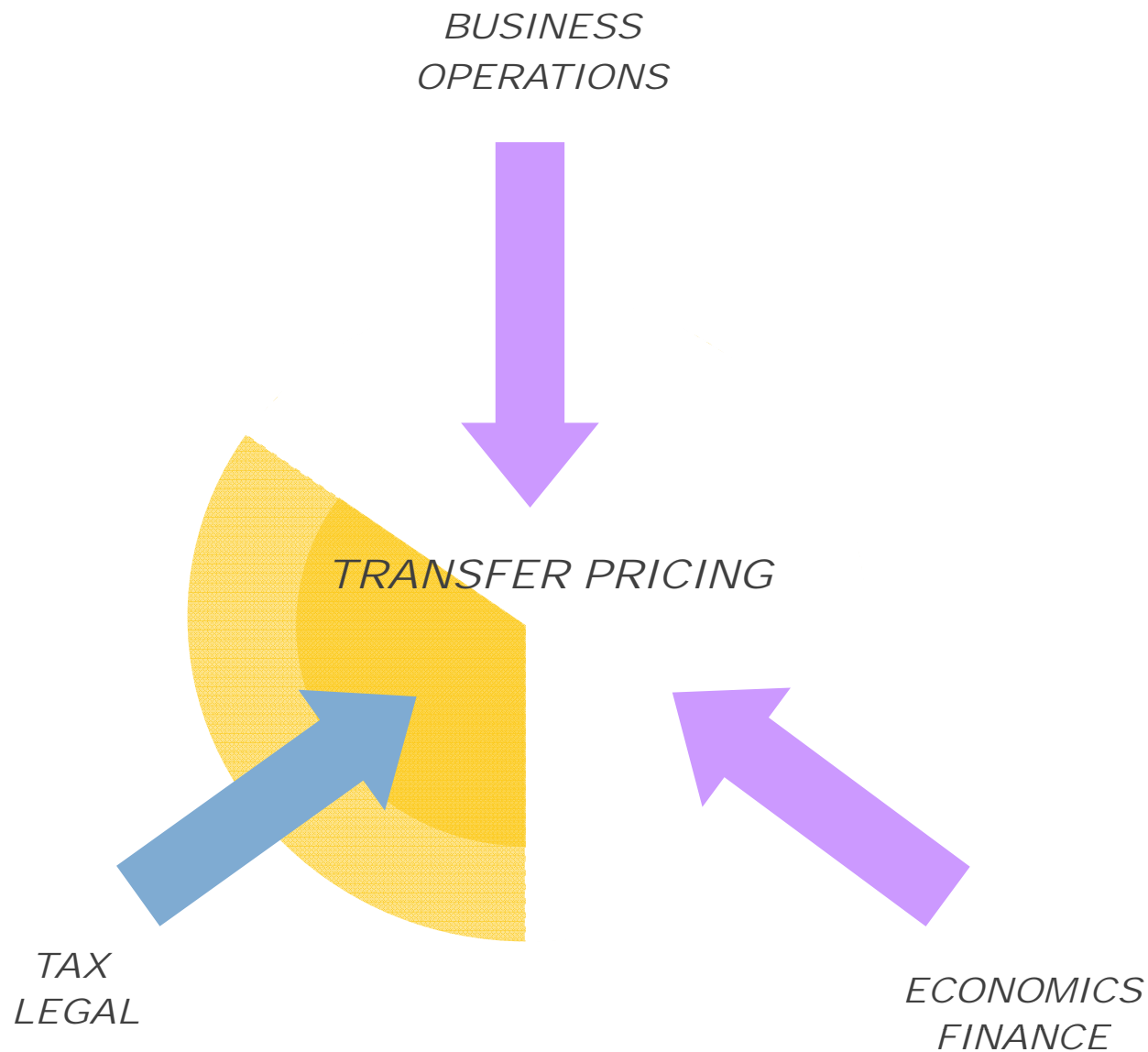
The Transfer Pricing Equation

- **How do you manage it?**
 - Key concept is “**arm’s length**”
 - Determine the price that would have been agreed between third parties, for a given transaction, under similar economic circumstances

- In order to meet the “**arm’s length**” **requirement**, it is essential to adequately map the “circumstances”
 - To design a transfer pricing system which is consistent with the way business operates, and follows its dynamics

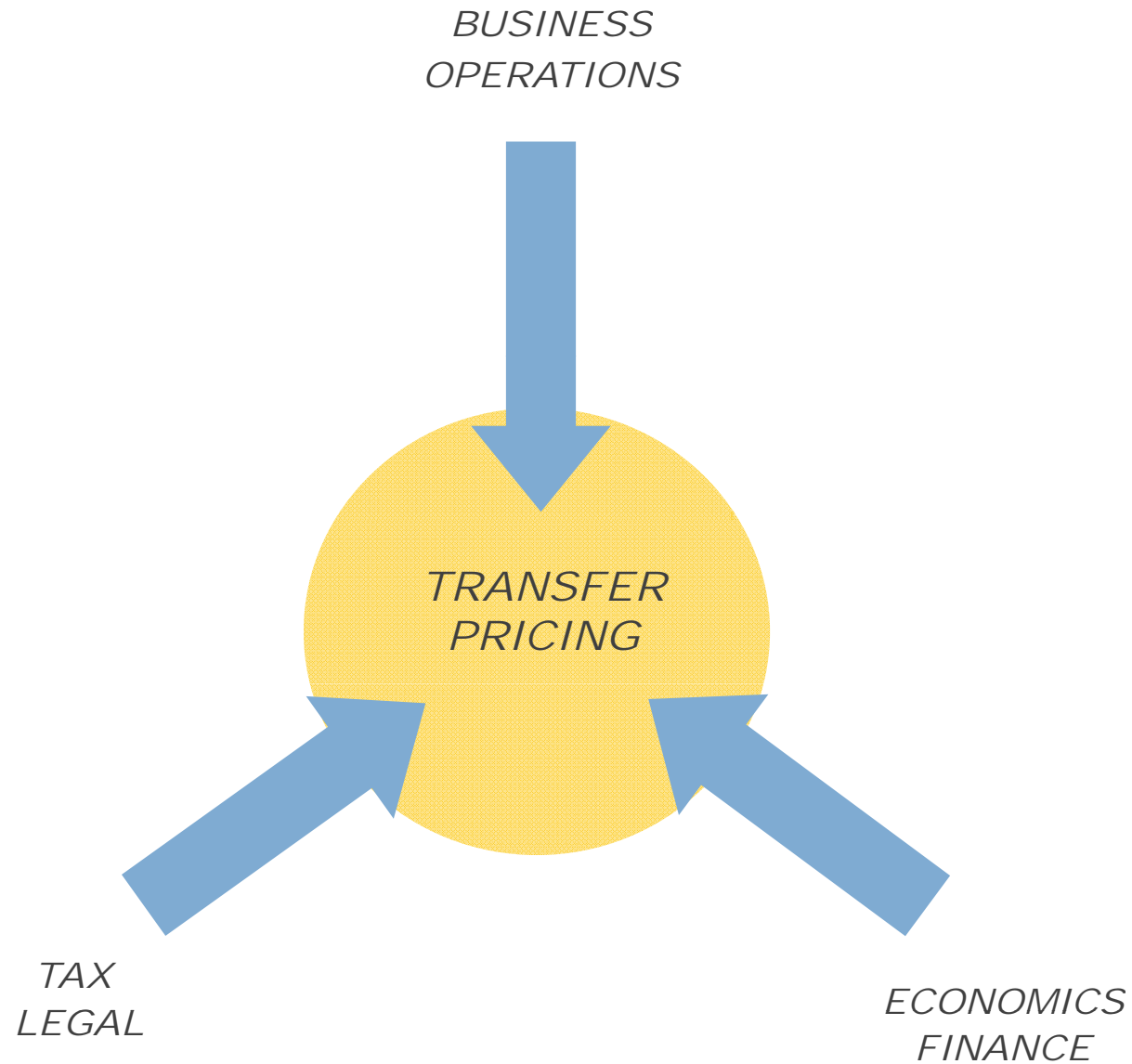


Meeting the Arm's Length Requirement – Beyond « Compliance »



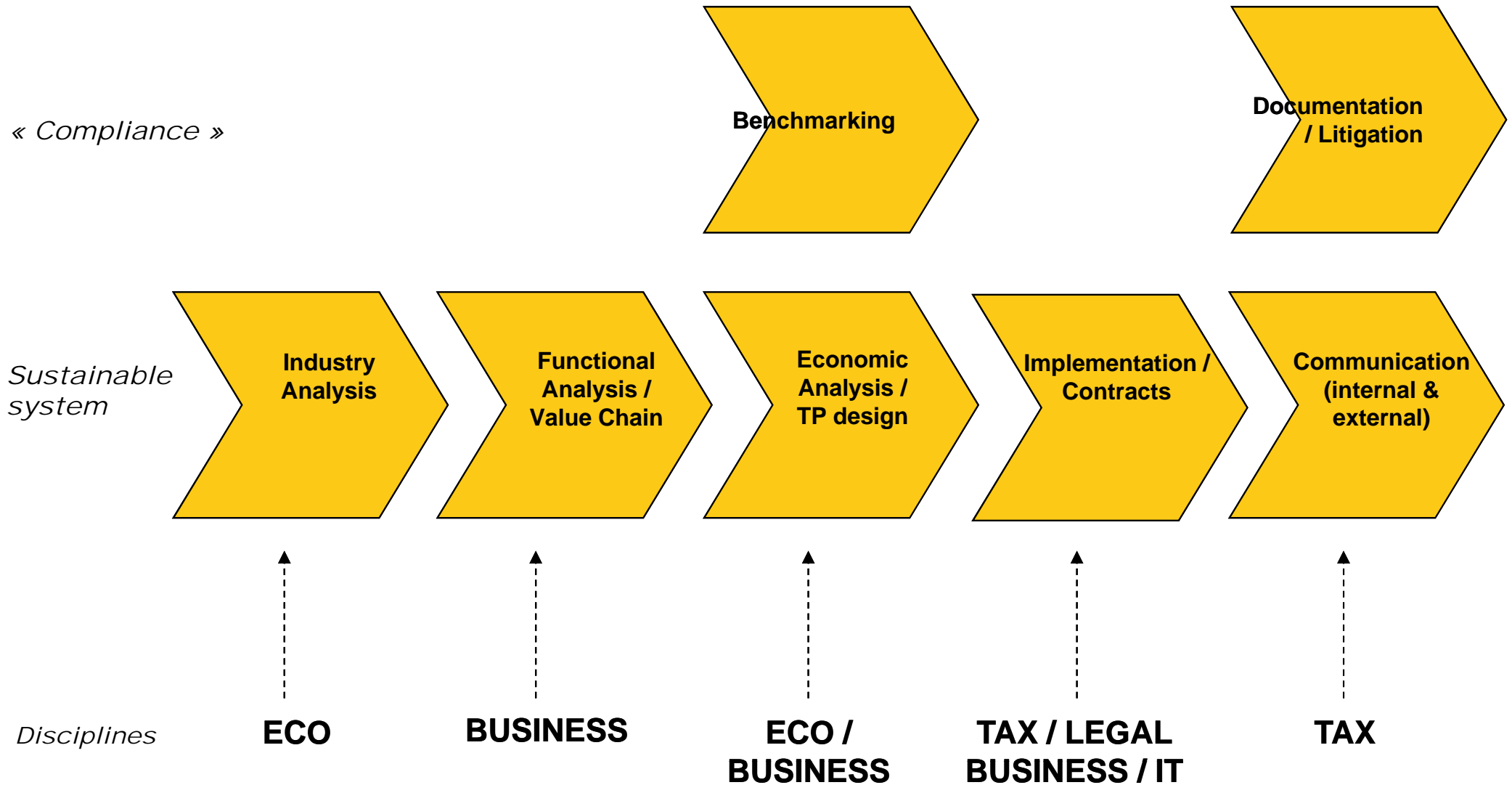


Meeting the Arm's Length Requirement – Sustainable Transfer Pricing System





Process For Designing an Arm's Length Transfer Pricing System





OECD developments and recent trends



The OECD's Role in the Promotion of the Arm's Length Principle

- **Revised Transfer Pricing Guidelines**
 - Chapters I -III Methods and Comparability (final & approved)
 - Chapter IX Business Restructurings (final & approved)

- **Attribution of Profits to Permanent Establishments (final & approved)**
 - 2010 version of the Report on the Attribution of Profits to Permanent Establishments

- **Intellectual Property (on-going)**



Revised Transfer Pricing Guidelines

Revised
Chapter II

1. New Guidance on the selection of the “most appropriate TP method to the circumstances of the case”
2. New guidance on how to apply the Transactional Net Margin Method and the Profit Split method in practice

New
Chapter III

3. New Guidance on comparability analysis

New
Chapter IX

4. New Guidance on the transfer pricing aspects of business restructurings

Extract from OECD presentation, Caroline Silberztein, IBC London, March 2011



New Guidance on the Transfer Pricing Aspects of Business Restructurings (Chapter IX)

What is a “business restructuring” in the context of the TP Guidelines?

- Cross-border redeployment by a multinational enterprise of functions, assets and risks; cross-border reallocation of profits (or loss) potential
 - Can involve the transfer of valuable intangibles, *although not* always the case
 - Can also, or alternatively, involve the termination or substantial renegotiation of existing arrangements.
 - example: conversion of “full fledged distributors” into “commissionaires”; of “full fledged manufacturers” into “toll-manufacturers”; etc
- 4 Parts:
 1. Risks
 2. Compensation of the restructuring itself
 3. Remuneration of post-restructuring transactions
 4. Recognition of transaction / recharacterisation issues





Attribution of Profits to PEs

- **The Authorized OECD Approach**

- **The Functionally Separate Entity Approach**

- To determine the profits attributable to the PE, a mechanism has to be developed for attributing risks, economic ownership of assets and capital to the **hypothetically distinct and separate PE**, for associating with the PE the rights and obligations derived from its “dealings” with other parts of the enterprise of which the PE is a part and from its transactions with related and unrelated parties.

- **The Significant People Functions**

- The significant people functions relevant to the assumption of **risks** are those which require **active decision-making** with regard to the acceptance and/or management (subsequent to the transfer) of those risks



Intellectual Property (1/2)

- Current guidance: Chapters VI and VIII of the TP Guidelines
- Major area of disputes / uncertainty for business and for governments
- Main areas covered
 - Definition / scope beyond traditional / accounting / legally protectable intangibles assets:
 - e.g. some marketing intangibles, workforce in place, business opportunities, etc:
 - Are these intangibles?
 - More importantly, should they be compensated at AL?



Intellectual Property (2/2)

- Main areas identified for possible future work
 - R&D; contract R&D
 - Know-how, employee assignments (=> Similarities and differences between the characterisation of a service or royalty for Article 12 purposes and the TP notion?)
 - Marketing intangibles
 - Business attributes and others
 - Identifying and characterizing an intangible transfer
 - Right of an enterprise to share in the return of an intangible it does not own:
 - Notions of “economic”, “beneficial”, “functional” ownership?
 - Cost contribution arrangements
 - Valuation of intangibles

Extract from OECD presentation, Caroline Silberztein, IBC London, March 2011





Transfer Pricing and Valuation Methods



Transfer Pricing Methods for Pricing Transactions

| | Comparable Uncontrolled Price Method (CUP) | Resale Price Method (RPM) | Cost Plus Method (CPLM) | Profit Split | Transactional Net Margin Method (TNMM) |
|----------|--|--|---|--|---|
| OVERVIEW | <ul style="list-style-type: none"> Comparable intra-group price to prices earned in comparable uncontrolled transactions under comparable circumstances Internal/External CUPs | <ul style="list-style-type: none"> Compares the intra-group resale margin (gross margin) to resale margin earned in comparable uncontrolled transactions under comparable circumstances | <ul style="list-style-type: none"> Compares the markup on costs of the tested party to the markups earned in comparable uncontrolled transactions under comparable circumstances | <ul style="list-style-type: none"> Splits the profits between the related companies engaged in the same transaction(s) based on the related value of each company's contribution to the combined profit | <ul style="list-style-type: none"> Compares the controlled company's profitability to the one of similar companies |
| PROS | <ul style="list-style-type: none"> "The most direct and reliable way" to apply the arm's length principle | <ul style="list-style-type: none"> Less comparability required than in the CUP method Well adapted to distribution activities | <ul style="list-style-type: none"> Less comparability required than in the CUP method Well adapted to manufacturing activities and provision of services | <ul style="list-style-type: none"> Adapted when both parties in the related-party transaction have developed significant intangible assets | <ul style="list-style-type: none"> Simple In practice, the most used Less comparability required than in CUP, RPM and CPLM |
| CONS | <ul style="list-style-type: none"> High comparability required (products, volumes, markets) Lack of publicly available data | <ul style="list-style-type: none"> Financial data (gross profit) of comparable companies may not be available Consistency of accounting standards | <ul style="list-style-type: none"> Financial data (gross profit) of comparable companies may not be available Consistency of accounting standards | <ul style="list-style-type: none"> Complex economic analysis Not adapted to all economic models | <ul style="list-style-type: none"> Ex-post / testing method Net margin may be impacted by non-transfer pricing issues |



Valuation Methods for Pricing Assets, Rights, Businesses or Companies

| | Cost approach | Market approach | Income approach |
|-------------------|--|--|---|
| Strengths | <ul style="list-style-type: none">• Seems easy to implement | <ul style="list-style-type: none">• Direct measure of the value of a company based on references to multiples derived from publicly-traded comparable companies and/or transactions | <ul style="list-style-type: none">• Most accurate measure of asset/company value, as equal to the net present value of expected future cash flows of the asset/company• Take into account the specificity of an (intangible) asset/company |
| Weaknesses | <ul style="list-style-type: none">• More complex than it seems• Replacement costs should be computed not actual costs• Provides a wrong measure, in general the lower end of the range | <ul style="list-style-type: none">• Reasonable level of comparability with the publicly-traded/acquired companies is necessary | <ul style="list-style-type: none">• Robustness of projections |
| Our point of view | <ul style="list-style-type: none">• The method is rarely used for asset/company valuation, except in cases where it is assumed that no value above the costs incurred is perceived to have been created | <ul style="list-style-type: none">• The method is frequently used for company valuation given the availability of publicly-traded/acquired companies• For asset valuation, multiples may not be readily available | <ul style="list-style-type: none">• The income approach provides the most accurate asset / company value |



The Economic Framework for Accurately Valuing IP

- Most firms originate their value and growth through a combination of unique know-how, intangibles, and value-creating activities
- Intellectual Property (IP) can generally be considered as key differentiators for the group and ultimately at the origin of a performance above average
- Accurate valuations can only be developed under the economic framework that reflects:
 - The **competitive advantage** to the user of the IP and
 - The **opportunity cost** to the owner of the IP
- The economic framework is superior to other valuation methods
 - Adapts to the specific context of the IP
 - Is best suited to deal with the uncertainty associated with IP

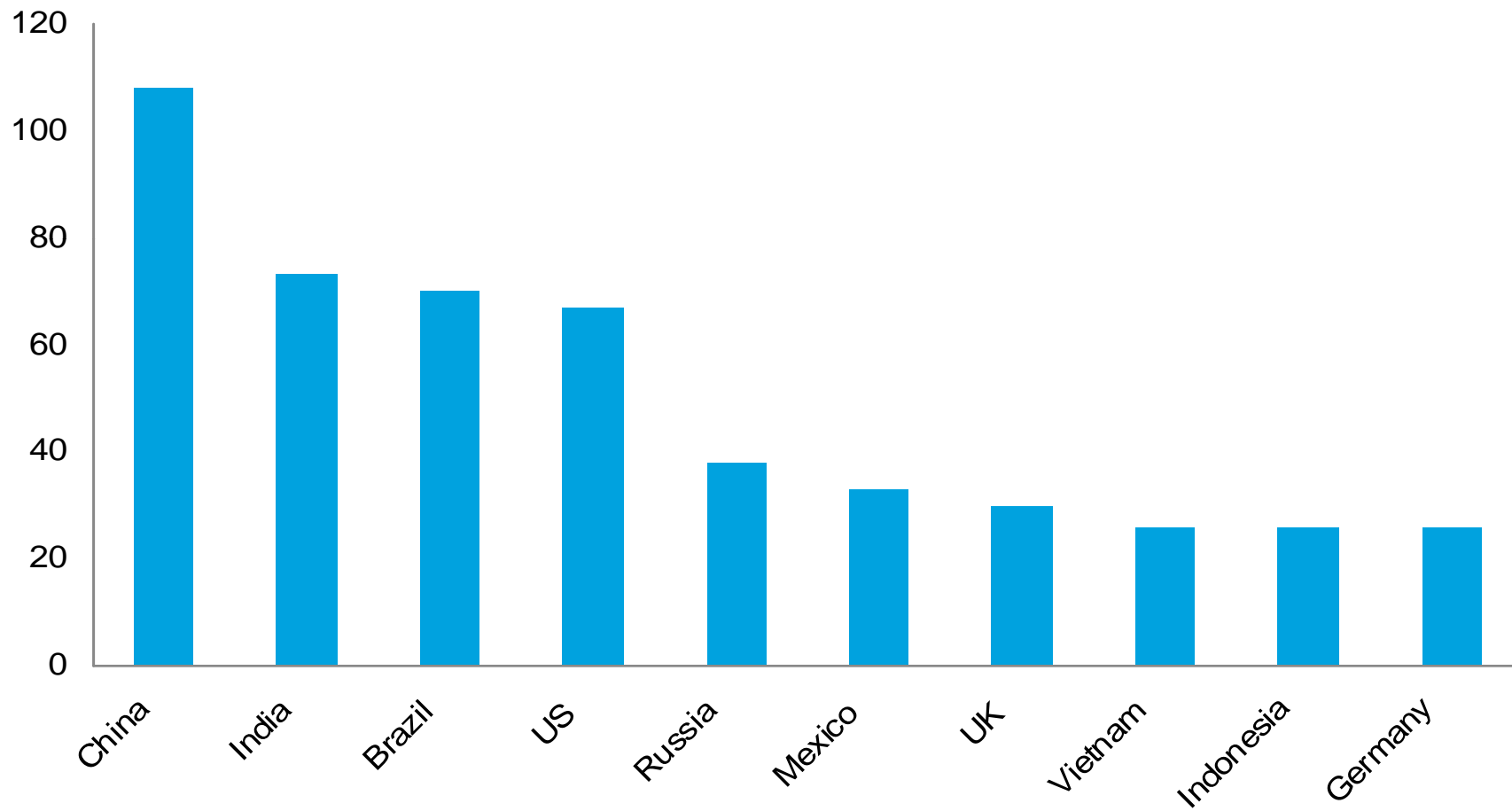


Transfer Pricing Challenges in the BRICS



Expected location of FDI by MNEs in 2011-2012

Number of responses

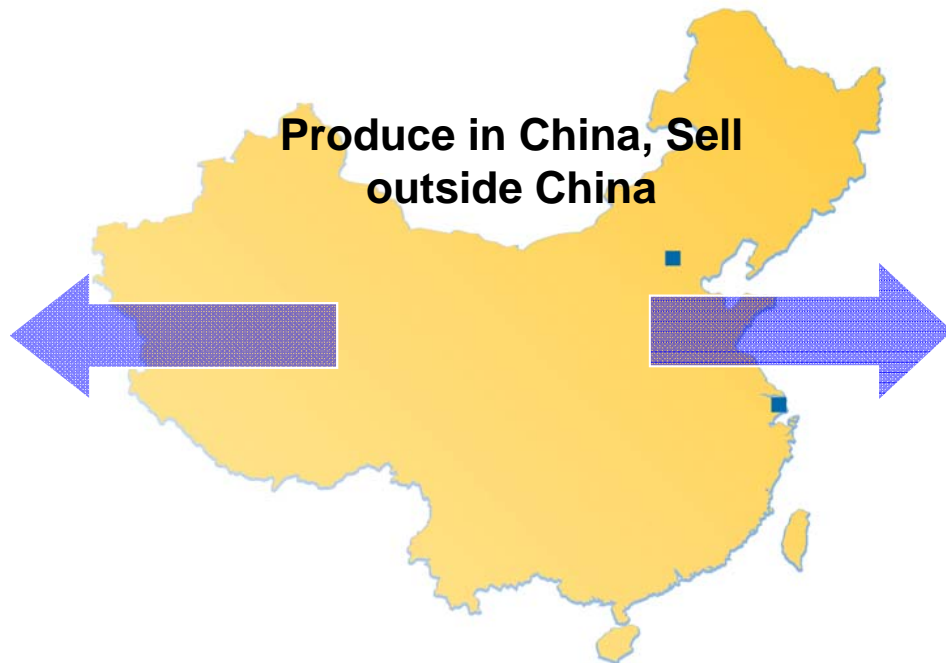


Source: World investment prospects survey 2010-2012 – United Nations



The BRICS's Economic Environment

2000 - 2010



Location savings at stake

2010 - 2020



Location savings at stake
and... « market premium »



Examples of Subjects at a Center Stage in China

“substantial market premium in the auto industry” (SAT, July 2010)

“location savings, intangibles, and market premiums” (SAT, April 2010)

“unique potential in the Chinese market” (Director Wang, head of APA program July 2009)

“how cost advantage impacts profitability” (Director Wang, head of APA program July 2009)

“RMB0.5 billion was collected as additional tax revenue in BAPA cases in 2009 applying the concepts of location saving and market intangible” (SAT)

