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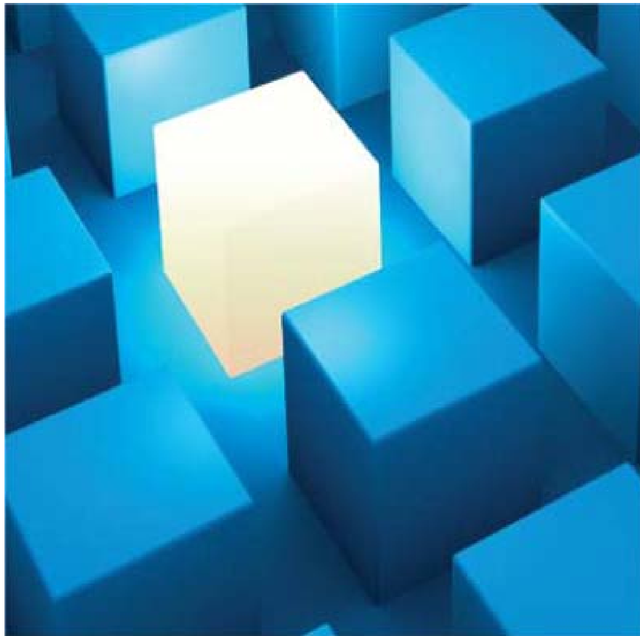

Introduction to Transfer Pricing Principles, Methods and Recent Developments

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

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What is Transfer Pricing?

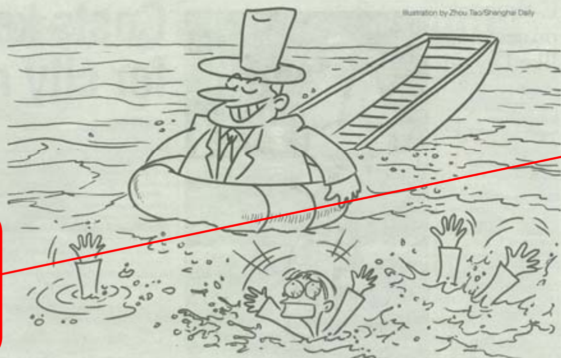
What is “Transfer Pricing”?!

Thursday 15 September 2011 | Shanghai Daily

A6 OPINION | www.shanghaidaily.com/opinion

Big American firms play dirty shell games

Paul Egerman



US taxpayers bankroll elephant in the room

Nassim Nicholas Taleb and Mark Spitznagel

“...bankers, having helped cause today’s financial and economic troubles, are the only class that is not suffering from them...”

Tax dodging companies are disinvesting in our country — not investing in it.

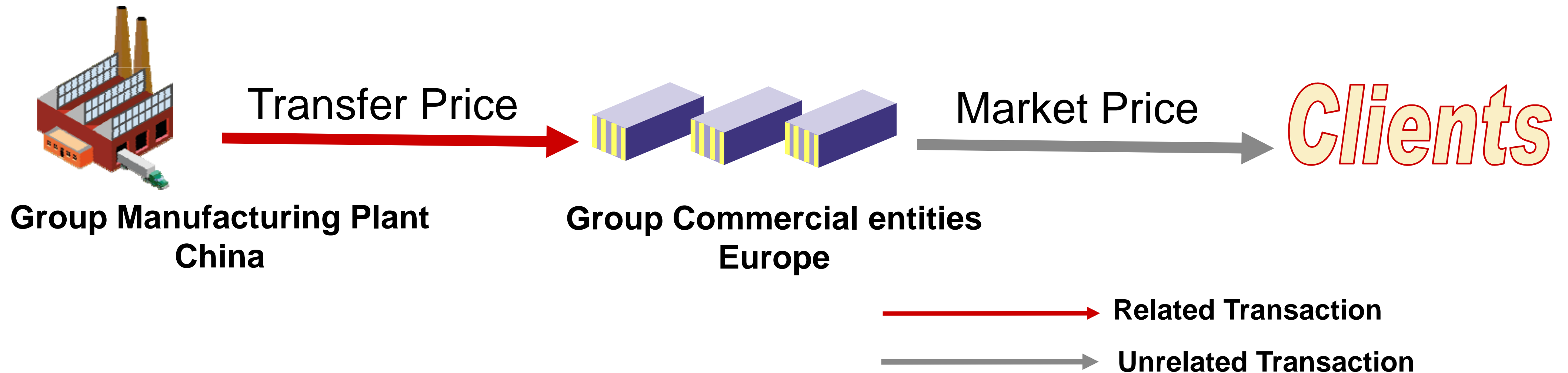
Many US multinational companies use a gimmick called “transfer pricing” — shifting patents to their offshore subsidiaries, for example — in order to pretend they’ve earned their profits in a tax haven like the Cayman Islands, Bermuda or Luxembourg, even though their operations there may be little more 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.

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	Budget / normal course of business	Following year / sudden drop in demand	
Volumes	10000	6000	
Transfer Price (per unit)	0.011	0.011	**0.013**
Revenues	110	66	77
Cost of Goods	35	21	21
OPEX – variable	40	24	24
OPEX - fixed	25	25	25
Operating profit	10	(4)	7
Return on total costs	10%	**-5.7%**	10%

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Case Study 2 - Selling in China

Group Parent (EU)
IP owner / Service Provider

WHAT REMUNERATION FOR PARENT'S IP AND SERVICES?

Market Price

Market Price

Clients in China

Third-party Manufacturing Plants Asia

Group Commercial Entity China

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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

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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 »

BUSINESS OPERATIONS

TRANSFER PRICING

TAX LEGAL

ECONOMICS FINANCE

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

BUSINESS
OPERATIONS

TRANSFER
PRICING

TAX
LEGAL

ECONOMICS
FINANCE

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Process For Designing an Arm's Length Transfer Pricing System

« Compliance »			Benchmarking		Documentation / Litigation
Sustainable system	Industry Analysis	Functional Analysis / Value Chain	Economic Analysis / TP design	Implementation / Contracts	Communication (internal & external)
Disciplines	ECO	BUSINESS	ECO / BUSINESS	TAX / LEGAL BUSINESS / IT	TAX

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

Chapter	Guidance
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

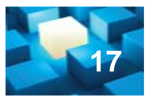
Extract from OECD presentation, Caroline Silberztein, IBC London, March 2011

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

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



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?

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

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	• Comparable intra-group price to prices earned in comparable uncontrolled transactions under comparable circumstances • Internal/External CUPs	• Compares the intra-group resale margin (gross margin) to resale margin earned in comparable uncontrolled transactions under comparable circumstances	• Compares the markup on costs of the tested party to the markups earned in comparable uncontrolled transactions under comparable circumstances	• 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	• Compares the controlled company's profitability to the one of similar companies
PROS	• "The most direct and reliable way" to apply the arm's length principle	• Less comparability required than in the CUP method • Well adapted to distribution activities	• Less comparability required than in the CUP method • Well adapted to manufacturing activities and provision of services	• Adapted when both parties in the related-party transaction have developed significant intangible assets	• Simple • In practice, the most used • Less comparability required than in CUP, RPM and CPLM
CONS	• High comparability required (products, volumes, markets) • Lack of publicly available data	• Financial data (gross profit) of comparable companies may not be available • Consistency of accounting standards	• Financial data (gross profit) of comparable companies may not be available • Consistency of accounting standards	• Complex economic analysis • Not adapted to all economic models	• Ex-post / testing method • Net margin may be impacted by non-transfer pricing issues

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Valuation Methods for Pricing Assets, Rights, Businesses or Companies

	Cost approach	Market approach	Income approach
Strengths	• Seems easy to implement	• Direct measure of the value of a company based on references to multiples derived from publicly-traded comparable companies and/or transactions	• 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	• 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	• Reasonable level of comparability with the publicly-traded/acquired companies is necessary	• Robustness of projections
Our point of view	• 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	• 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	• 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

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Transfer Pricing Challenges in the BRICS

BRICS and FDIs

Expected location of FDI by MNEs in 2011-2012

Number of responses

120
100
80
60
40
20
0

China
India
Brazil
US
Russia
Mexico
UK
Vietnam
Indonesia
Germany

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

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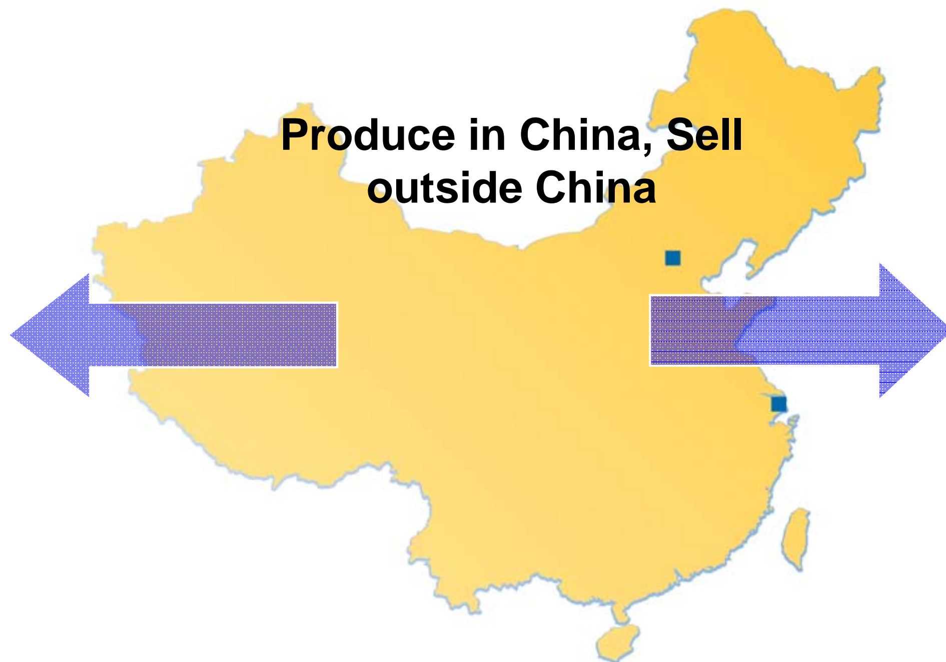
The BRICS's Economic Environment

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)

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