OECD Guidelines on Transfer Pricing and UN Manual on Transfer Pricing

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Outline of presentation

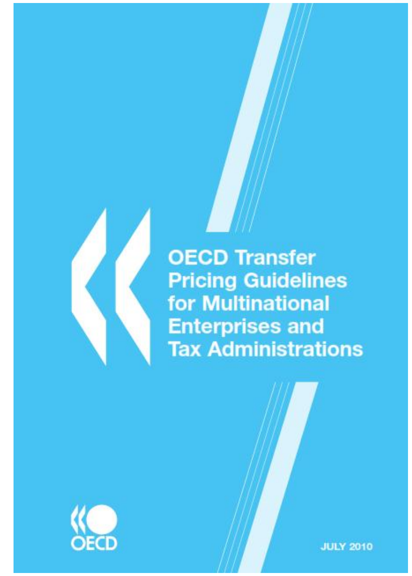
- Evolution of Transfer Pricing
- Transfer Pricing & UN/OECD Model Tax Convention
- The concept of control
- Multinational Structures
- The Arms length Principle and its alternative
- Comparability
- Transfer Pricing Methodology

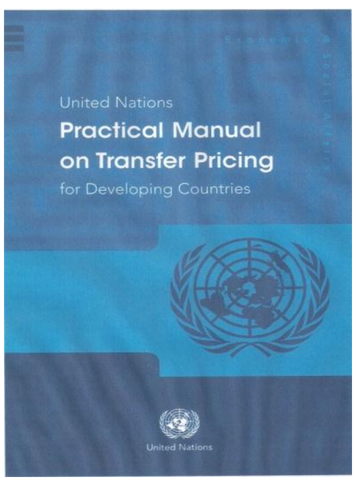
Evolution of Transfer Pricing

- OECD published earlier reports on Transfer Pricing in 1979 and 1984 before publishing the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations in 1995. The guidelines are OECD members responses to the revolutionary changes in how businesses and financial instruments are structured from mid 1990s to date.
- The United Nations also published the Practical Manual on Transfer Pricing for Developing Countries in 2013

TP AND UN/OECD MTC

Arm's Length Principle*
embodied in the
UN/OECD Model Tax
Convention
Article 9





Application Guidelines/Interpretation Tool for Article 9 of the UN/OECD Model Tax Convention on Income and Capital.

*** ALP may also be mentioned in legislation (enacted in domestic law), regulations, rulings, case law or guidelines.**

Contents of OECD TP Guidelines

- The Arm's Length Principle
- Transfer Pricing Methods
- Comparability Analysis
- Avoiding And Resolving Transfer Pricing Disputes
- Documentation
- Intangibles
- Intra Group Services
- Cost Contribution Arrangements
- Business Restructuring

Contents of the UN TP Manual

- Introduction to Transfer Pricing
- Business Framework
- The General Legal Environment
- Establishing Transfer Pricing Capability in Developing Countries
- Comparability Analysis
- Transfer Pricing Methods
- Documentation
- Audits and Risk Assessment
- Dispute Avoidance and Resolution
- Country Practices

Definition of "Associated Company" - Control -

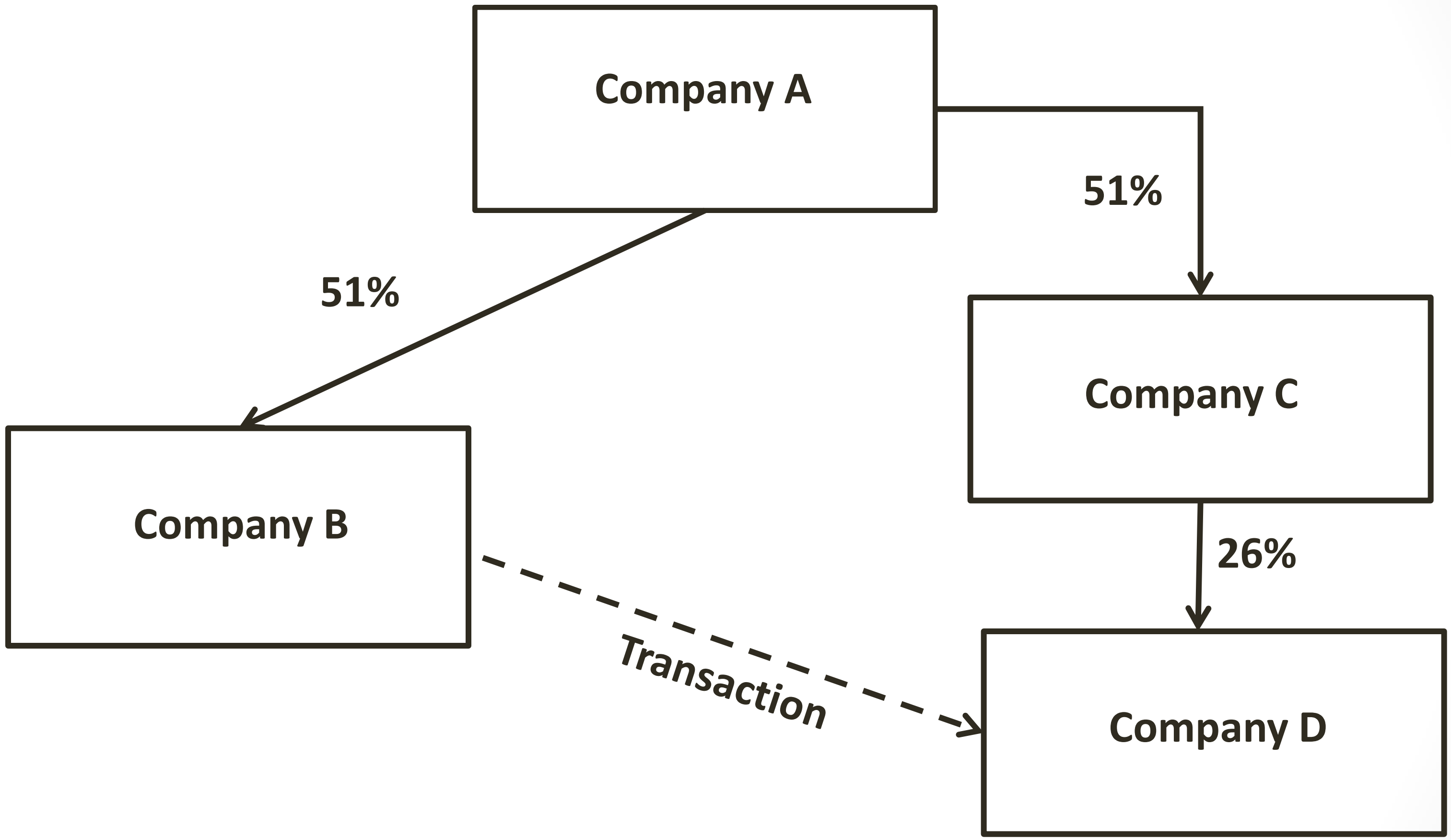
- Definition in Article 9 UN/OECD Model Tax Convention:

  "Direct or indirect participation in the
  - *management,*
  - *control or*
  - *capital of an enterprise"*
- No minimum level of participation
- Enterprises are associated where:
  - one enterprises controls the other
  - or both are controlled by the same person or persons

Definition of Control (2)

- Shareholding (de jure control): often > 50%
- De facto control, e.g.
  - same directors in both enterprises
  - sole customer or supplier
  - Major financier

Control



Are B and D
associated enterprises?

MNE Structures

- Since the mid 90s: typically, conversion of “full fledged distributors” into “commissionaires”; of “full fledged manufacturers” into “toll-manufacturers”; etc
- Migration of intangible assets and of risks, together with associated profit potential, often to low tax jurisdictions
- Business: reasons for reallocation are, amongst others, the wish to maximise synergies and economies of scale, to streamline management of business lines and to improve the efficiency of the supply chain

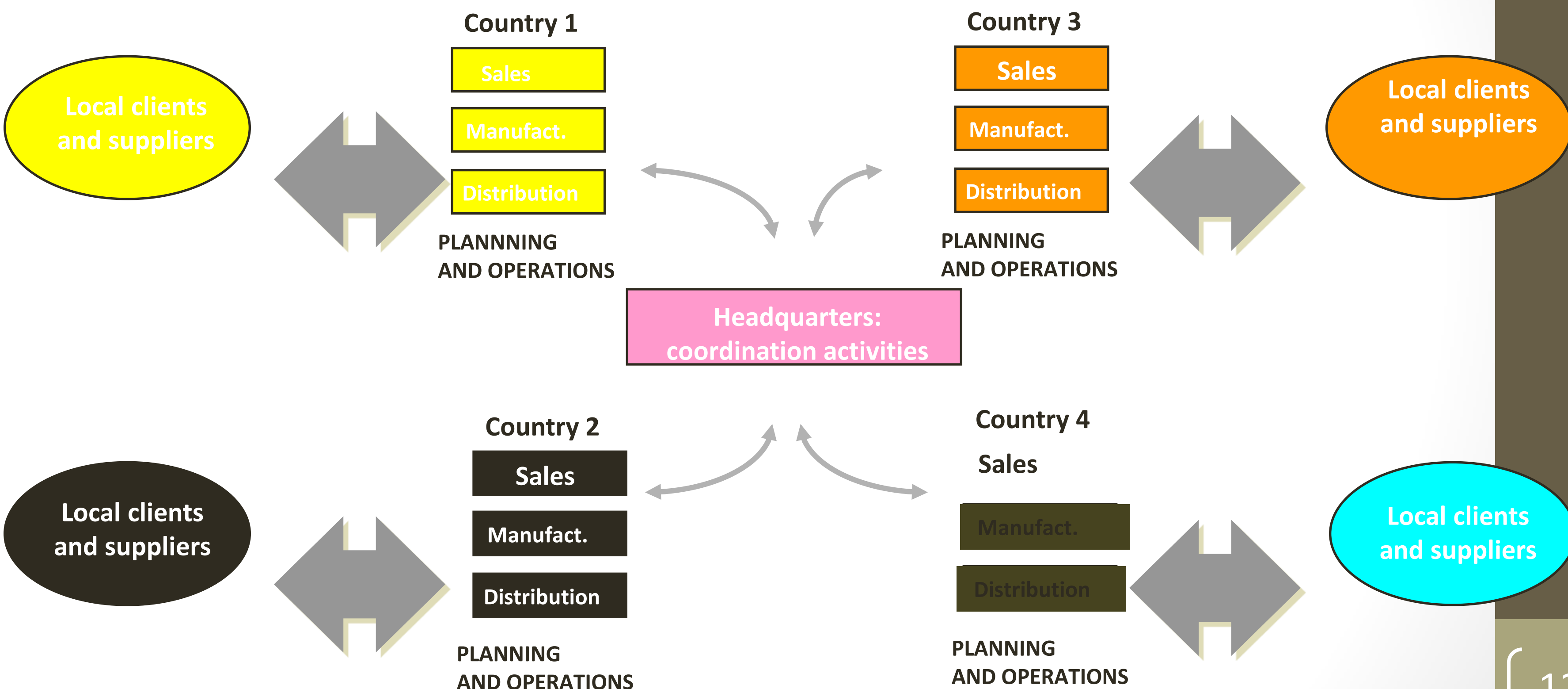
Traditional business model – Decentralised

Businesses organised around countries or geographic regions with their own:

- customers and suppliers
- manufacturing facilities
- sales and distribution network
- R&D facilities
- brands and products
- management

.

Traditional business model

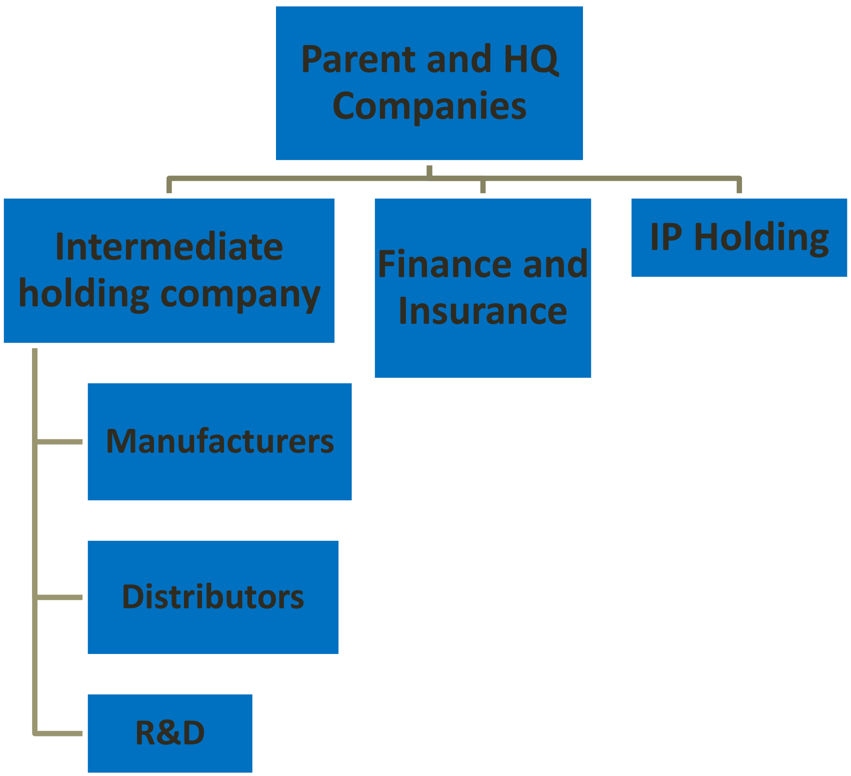


Centralised business model

The business is undertaken on a more global or regional scale with:

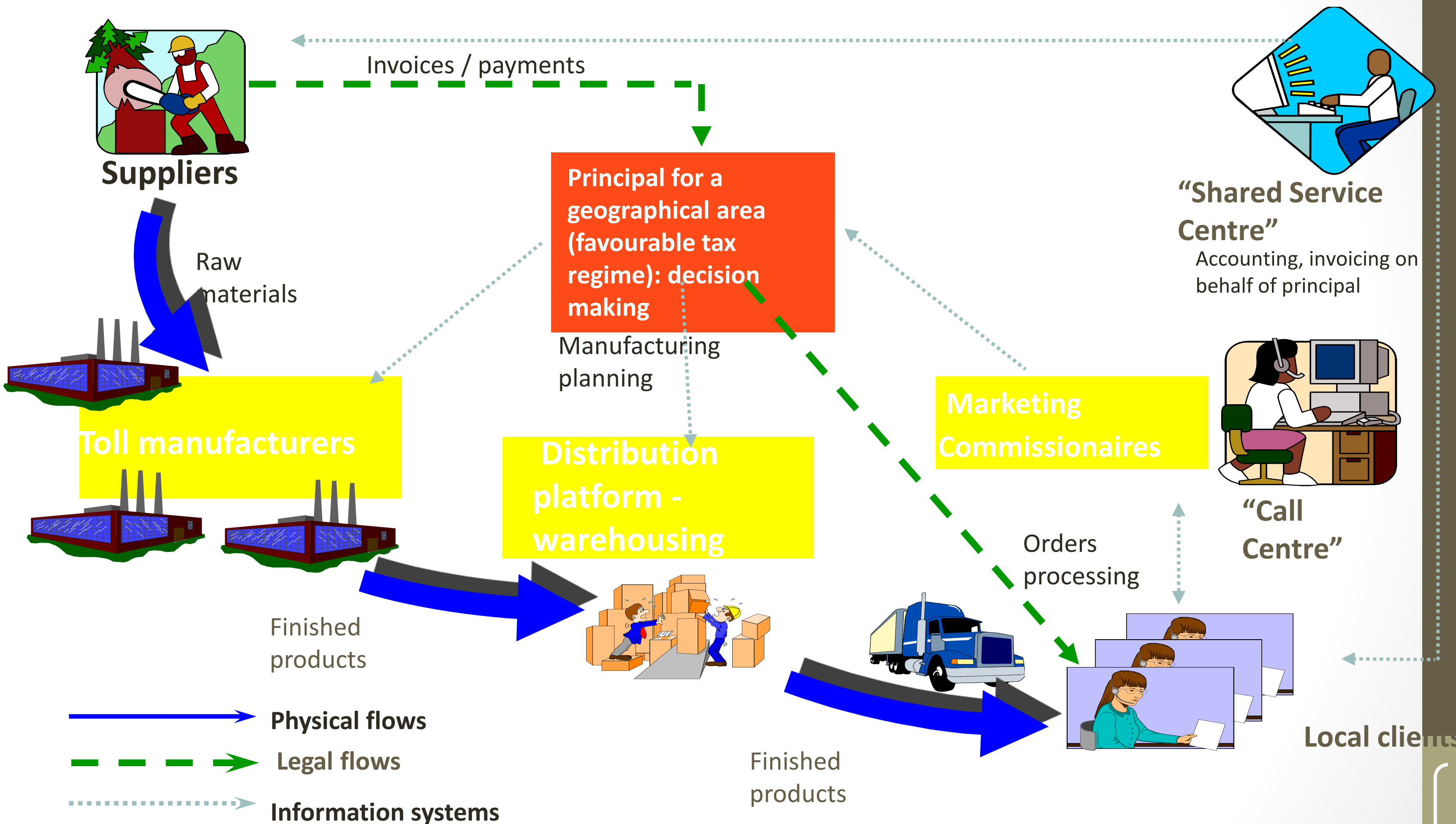
- International brands
- Global goods
- Manufacturers producing for a global rather than a country market
- International sales and marketing networks – with global customers
- Centrally owned intellectual property
- Centrally managed supply chain

MNE international structure



- MNEs are made up of separate taxable entities that are connected by share ownership
- Functional organisation does not necessarily match legal organisation
- Changing business structures: from traditional to centralised business model:
  - From businesses organised around countries or geographic regions with their own functions, to business organised on a more global or regional scale with functions performed for global markets rather than country market

Illustration: global business model



THE ARM'S LENGTH PRINCIPLE

- Article 9(1) OECD Model Tax Convention:

  "(....) where conditions made or imposed between associated enterprises in their commercial or financial relations differ from those which would have been made between independent enterprises, then profits that, but for those conditions, would have accrued to one of the enterprises may be included in the profits of that enterprise and taxed".

THE ARM’S LENGTH PRINCIPLE

Article 9 (1) of UN Model Tax Convention states:“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, or
- (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case 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, but, by reason of these conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly

ALP Example

- For example, a South African gold refinery and marketing company buys unrefined gold from its own subsidiary, a gold mining company, in Ghana. The price the South African parent pays its subsidiary ie the transfer price will determine how much profit the Ghanaian subsidiary will report and how much local tax it pays. If the parent company pays below normal local market prices, the Ghanaian company may appear to be in financial difficulty, even if the group as a whole shows a decent profit margin when the gold is sold.

ALP Example

- The South African tax administrators might not grumble as the profit will be reported at their end, but their Ghanaian counterparts will be disappointed not to have much profit to tax on their side of the operation. This problem only arises inside corporations with subsidiaries in more than one country

ALP Example

- If the South African gold refinery and marketing company bought its unrefined gold from an independent company in Ghana it would pay the market price, and the supplier would pay taxes on its own profits in the normal way. It is the fact that the various parts of the group are under some form of common control that is important for the tax authority as this may mean that transfers are not subject to the full play of market forces.

Formulary Approach

- The alternative to the Arm’s Length Principle is some kind of formulary apportionment that would split the entire profits of an MNE among all its subsidiaries, regardless of their location. However, proponents of such alternative not only have to show that their proposals are theoretically “better” but that they are capable of winning international agreement.

Formulary Approach

- They are finding it difficult to convince both tax administrators and multinationals, since the very act of building a formula makes it clear what the outcome is intended to be and who the winners and losers will be for a given set of factors.
- So far it is very difficult to reach agreement on basis of any formula to apportion profits among related companies particularly between parent companies in different economies

ALP as the solution

ALP avoids the problems of the formulary approach as it is based on real markets. It is tried and tested, offering MNEs and governments a single international standard for agreements that give different governments a fair share of the tax base of MNEs in their jurisdiction while avoiding double taxation problems.

Comparability

- The application of the arm’s length principle is generally based on a comparison of conditions in a controlled transaction with the conditions in transactions between independent enterprises.
- To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. If suitable adjustments cannot be made, then the dealings cannot be considered comparable.

Factors Determining Comparability

- Characteristics of property or services
  - for instance trade mark versus a simple nail
- Functional analysis
  - Functions performed; risks assumed; assets used
- Contractual terms
  - How are risks, benefits and responsibilities divided
  - Analyze terms whether written or oral, explicit or implied
  - When true terms differ from written terms: then further investigation
- Economic circumstances
  - geographic; size market; competition; substitutes
- Business strategies
  - e.g. market penetration; innovation; diversification/ specialization

Other Factors to Consider

- Recognition of actual transactions
  - do not disregard or substitute actual transactions
  - 2 exceptions: (1) substance over form and (2) the form is correct but totality of arrangements is not AL AND impedes practically determining an AL price
- Losses
  - Do not necessarily indicate transfer pricing abuse
- Effect of government policies
  - How would independent companies deal with it

TRANSFER PRICING METHODS

- Traditional transaction methods:
  - Comparable Uncontrolled Price (CUP)
  - Cost plus method
  - Resale price method

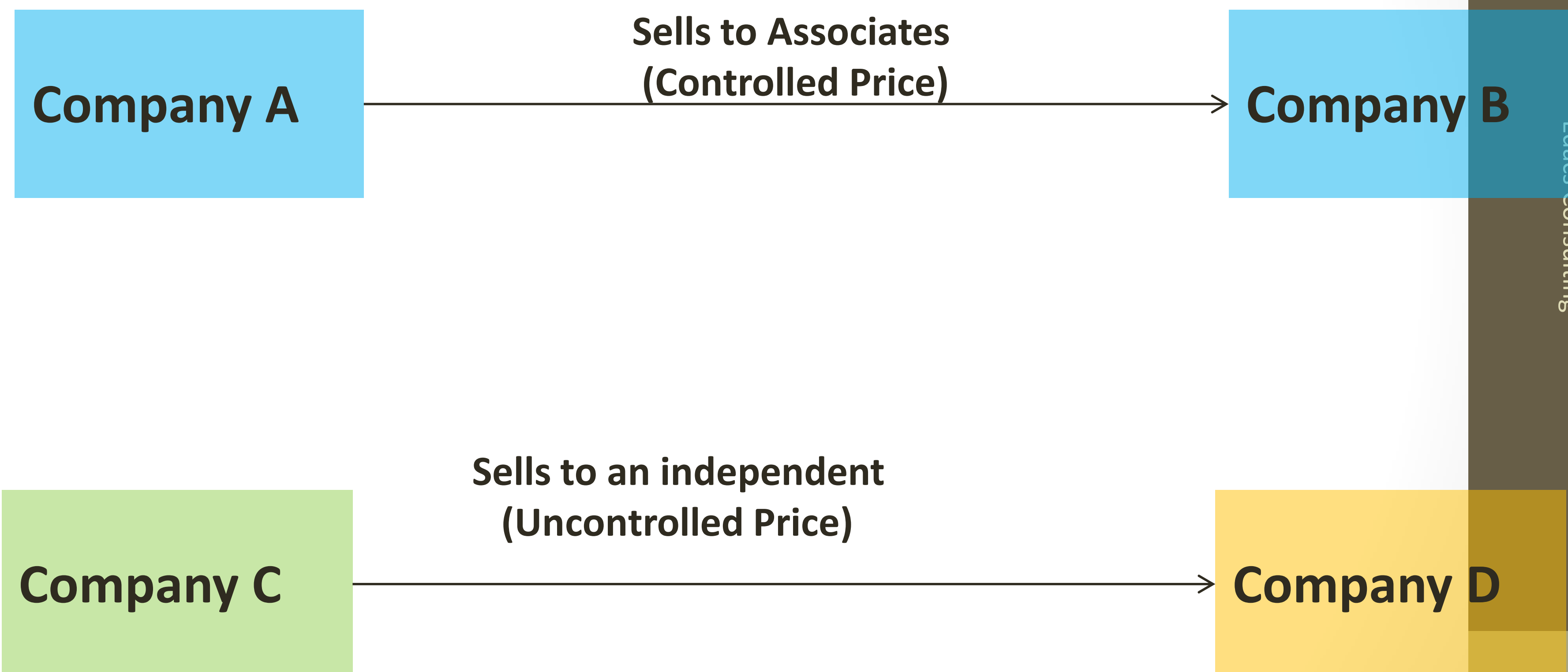
Gross profit level indicator

- Transactional profit methods:
  - Transactional Net Margin Method (TNMM)
  - Profit Split method

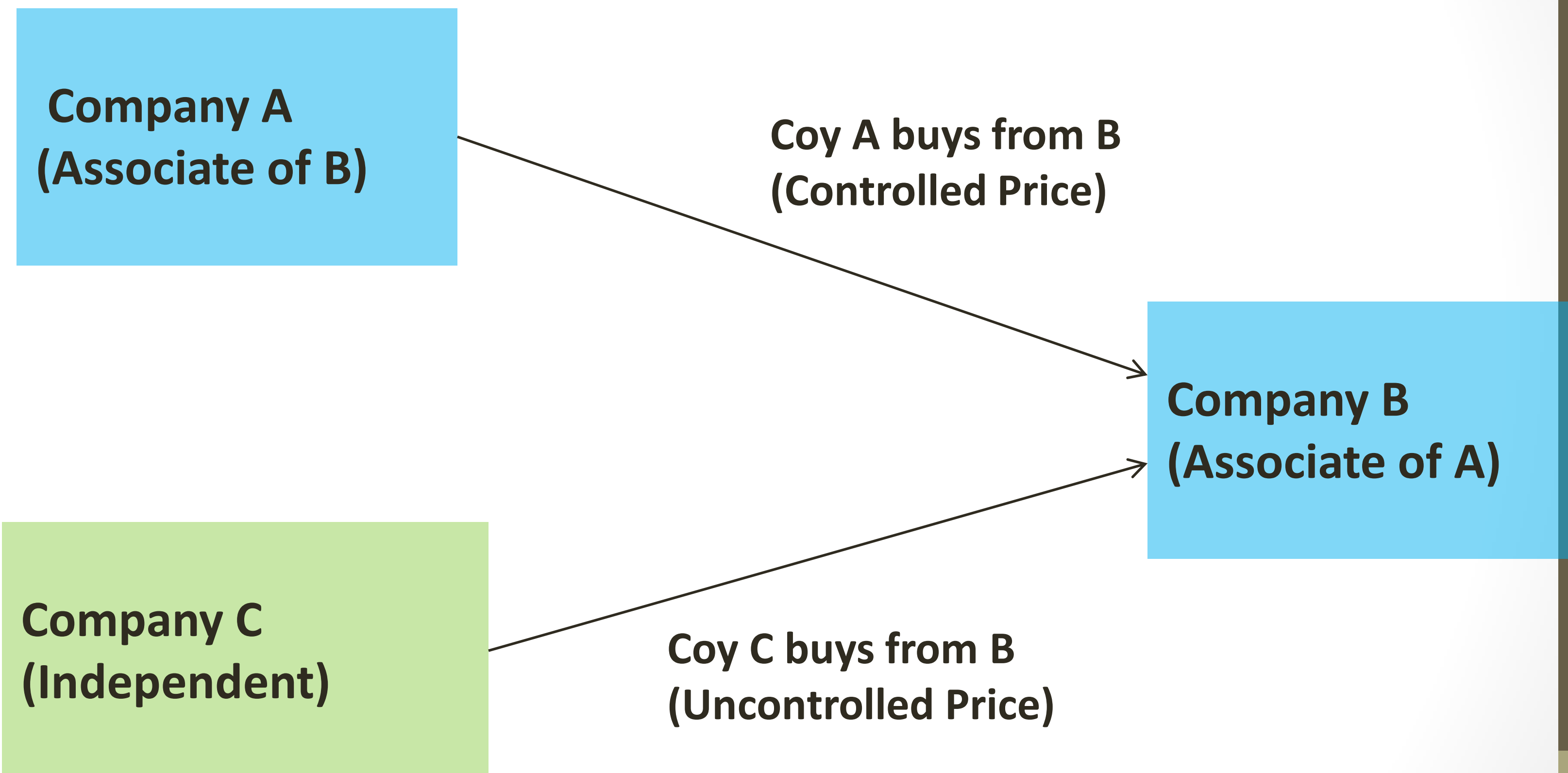
Net profit level indicator

- The selected method should be the "most appropriate method to the circumstances of the case"

CUP METHOD
External Comparison



CUP METHOD
Internal Comparison (Buying)



CUP METHOD
Internal Comparison (Selling)

Company A
(Associate of B)

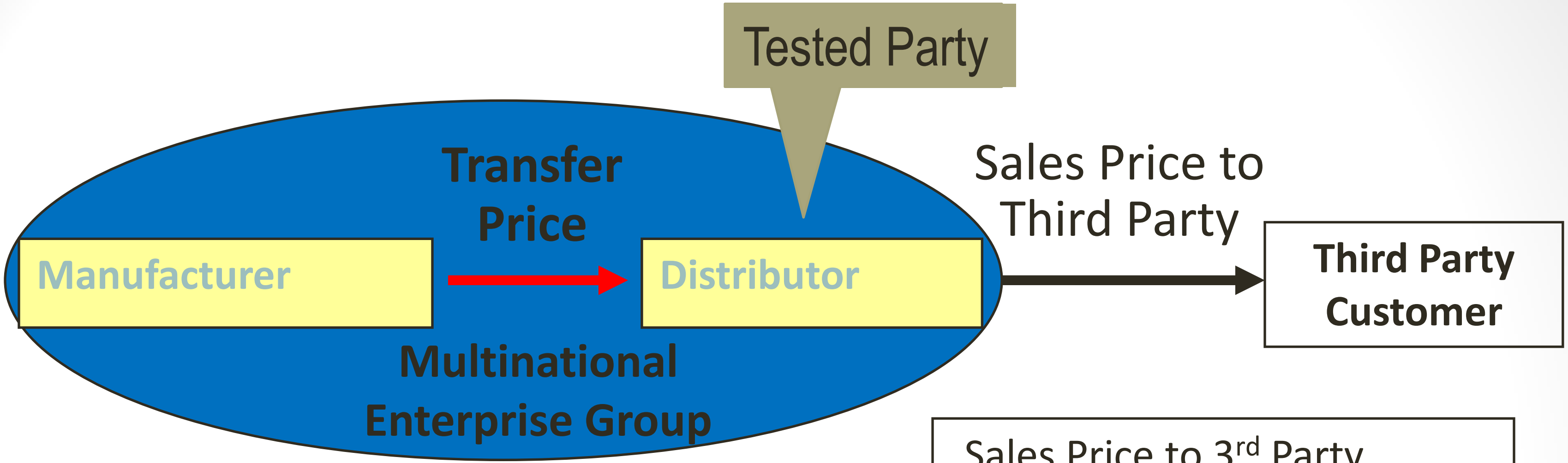
Coy A sells to Coy B
(Controlled Price)

Company B
(Associate of A)

Coy A sells to Coy C
(Uncontrolled Price)

Company C
(Independent)

RESALE PRICE METHOD



Sales Price to 3rd Party
- Gross Profit Margin
Transfer Price

- Examines gross profit relative to sales
- Calculate gross margin for distributor/reseller

Example: Resale Price Method

Cornel SA is the South African distributor of Helix brand washing machines. It sources its stocks from its parent company in China. The margin earned by similar washing machine distributors in South Africa is 15%. The price per the Helix brand washing machine to customers is Rand 3000. The cost per television to Cornel SA is Rand 2500. As a Transfer Specialist engaged by Cornel SA, you tried to get further information from the group without success.

Required

With the information at your disposal, compute the transfer price using the most appropriate transfer pricing method.

Example: Resale Price Method

Note: 3000 x 15/115 = 391.2

Price Charged to customers	3000.00
Margin 15%	391.20
Transfer Price (3000 – 391.2)	2608.80
Import Price	2500.00
TP Adjustment (2608.8 – 2500)	108.80

TNMM METHOD

- Examines the net profit margin relative to an appropriate base that a taxpayer realizes from a controlled transaction, e.g.
  - Sales
  - Costs
  - Assets
  - Berry ratio (gross profit over operating expenses)
  - Other PLI (e.g. # of employees, time, floor area, …)
- Net margin computed after all operating expenses (except extraordinary items, interest and taxes)
- The TNMM must be applied in a manner consistent with resale price/cost plus method

PROFIT SPLIT METHOD

- Each of the parties contribute unique intangibles or assume unique risks

- 2 types of profit split method:
  - <u>Contribution analysis</u>: compute combined net profit + assign a profit split percentage
  - <u>Residual analysis</u>: compute combined net profit of associated enterprises + use other methods to assign basic return to each (routine) function of each company and divide residual profit according to a contribution analysis

Residual Profit Split

Under the residual profit split approach, each of the parties to the transaction is assigned a portion of profit according to the basic functions that it performs. The residual profit or loss is then allocated between the parties on the basis of their relative economic contribution in respect of the amount to be allocated.

Profit Split
Contribution Analysis

Under the contribution analysis approach, it is generally the combined operating profit (profit before interest and tax) that is divided between the parties on the basis of the relative contribution of each party to that combined gross profit.

Documentations

- Broadly, the information or documents that the taxpayer needs to provide can be classified as:
- 1. Enterprise-related documents such as shareholding structure, business activity profile and industry analysis
- 2. Transaction-specific documents such as details of international transaction, comparability analysis of the taxpayer and its related enterprises and record of all uncontrolled transactions
- 3. Computation-related documents such as the nature of each related party transaction and rationale for selecting a Transfer Pricing method for each cross border transaction and computation of the arm's length price

Contemporaneous documentation

- The term "contemporaneous" means "existing or occurring in the same period of time".
- Different countries have different interpretations about how the word "contemporaneous" is to be interpreted with respect to transfer pricing documentation.
- Some interpret it to mean using comparables that are contemporaneous with the transaction, regardless of when the documentation is produced or when the comparables are obtained. Other countries interpret contemporaneous to mean using only those comparables available at the time the transaction occurs.

Thank you !