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”?! 

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

Group Manufacturing Plant
China

Transfer Price

Group Commercial entities
Europe

Market Price

Clients

Related Transaction

Unrelated Transaction

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### Case study 1 - Producing in China

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

#### Plant P&L

<table>
<thead>
<tr>
<th></th>
<th>Budget / normal course of business</th>
<th>Following year / sudden drop in demand</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Volumes</td>
<td>10000</td>
</tr>
<tr>
<td>Transfer Price (per unit)</td>
<td>0.011</td>
<td>0.011</td>
</tr>
<tr>
<td>Revenues</td>
<td>110</td>
<td>110</td>
</tr>
<tr>
<td>Cost of Goods</td>
<td>35</td>
<td>35</td>
</tr>
<tr>
<td>OPEX – variable</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>OPEX - fixed</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>Operating profit</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Return on total costs</td>
<td>10%</td>
<td>-5.7%</td>
</tr>
</tbody>
</table>

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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

Third-party Manufacturing Plants Asia

Group Commercial Entity China

Clients 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

« Compliance »

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

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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

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

3. New Guidance on comparability analysis

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

Extract from OECD presentation, Caroline Silberztein, IBC London, March 2011
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
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.
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?
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
Transfer Pricing and Valuation Methods
## Transfer Pricing Methods for Pricing Transactions

<table>
<thead>
<tr>
<th><strong>Comparable Uncontrolled Price Method (CUP)</strong></th>
<th><strong>Resale Price Method (RPM)</strong></th>
<th><strong>Cost Plus Method (CPLM)</strong></th>
<th><strong>Profit Split</strong></th>
<th><strong>Transactional Net Margin Method (TNMM)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Comparable intra-group price to prices earned in comparable uncontrolled transactions under comparable circumstances</td>
<td>• Compares the intra-group resale margin (gross margin) to resale margin earned in comparable uncontrolled transactions under comparable circumstances</td>
<td>• Compares the markup on costs of the tested party to the markups earned in comparable uncontrolled transactions under comparable circumstances</td>
<td>• 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</td>
<td>• Compares the controlled company’s profitability to the one of similar companies</td>
</tr>
<tr>
<td>• Internal/External CUPs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• &quot;The most direct and reliable way&quot; to apply the arm’s length principle</td>
<td>• Less comparability required than in the CUP method</td>
<td>• Less comparability required than in the CUP method</td>
<td>• Simple</td>
</tr>
<tr>
<td></td>
<td>• Well adapted to distribution activities</td>
<td>• Well adapted to manufacturing activities and provision of services</td>
<td>• Adapted when both parties in the related-party transaction have developed significant intangible assets</td>
<td>• In practice, the most used</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Less comparability required than in CUP, RPM and CPLM</td>
</tr>
<tr>
<td><strong>CONS</strong></td>
<td><strong>PROS</strong></td>
<td><strong>CONS</strong></td>
<td><strong>PROS</strong></td>
<td><strong>CONS</strong></td>
</tr>
<tr>
<td>• High comparability required (products, volumes, markets)</td>
<td>• Financial data (gross profit) of comparable companies may not be available</td>
<td>• Financial data (gross profit) of comparable companies may not be available</td>
<td>• Complex economic analysis</td>
<td>• Ex-post / testing method</td>
</tr>
<tr>
<td>• Lack of publicly available data</td>
<td>• Consistency of accounting standards</td>
<td></td>
<td>• Not adapted to all economic models</td>
<td>• Net margin may be impacted by non-transfer pricing issues</td>
</tr>
</tbody>
</table>
### Valuation Methods for Pricing Assets, Rights, Businesses or Companies

<table>
<thead>
<tr>
<th>Cost approach</th>
<th>Market approach</th>
<th>Income approach</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Strengths</strong></td>
<td><strong>Weaknesses</strong></td>
<td><strong>Our point of view</strong></td>
</tr>
<tr>
<td>• Seems easy to implement</td>
<td>• More complex than it seems</td>
<td>• 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</td>
</tr>
<tr>
<td></td>
<td>• Replacement costs should be computed not actual costs</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Provides a wrong measure, in general the lower end of the range</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>• The income approach provides the most accurate asset / company value</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Most accurate measure of asset/company value, as equal to the net present value of expected future cash flows of the asset/company</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Take into account the specificity of an (intangible) asset/company</td>
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<tr>
<td></td>
<td></td>
<td>• Robustness of projections</td>
</tr>
<tr>
<td></td>
<td><strong>Reasonable level of comparability with the publicly-traded/acquired companies is necessary</strong></td>
<td></td>
</tr>
</tbody>
</table>
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

China, India, Brazil, US, Russia, Mexico, UK, Vietnam, Indonesia, Germany

The BRICS’s Economic Environment

2000 - 2010

Location savings at stake

Produce in China, Sell outside China

2010 - 2020

Location savings at stake and… « market premium »

Produce in China (or outside), Sell in China

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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)