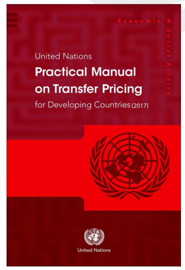
UN-ATAF Workshop on Transfer Pricing
Administrative Aspects and Recent Developments
Ezulwini, Swaziland
4-8 December 2017

AFRICAN TAX ADMINISTRATION FORUM

INTRODUCTION TO TRANSFER PRICING

Monday, 4 December 2017
9.30am – 11.00am



LEARNING OBJECTIVES

Understanding the basic elements of transfer pricing

- What is transfer pricing?
- The arm's length principle
- Legal Environment
- Conducting a Transfer Pricing Analysis

OVERVIEW

- What is transfer pricing and why is it important?
- The arm's' length principle
- Elements of a transfer pricing analysis:
  - Functional analysis
  - Comparables and comparability analysis
  - Transfer pricing methods
- The business framework
- The legal environment

What is Transfer Pricing and Why is it Important?

A SIMPLE EXAMPLE

- Company A manufactures automobiles in Japan that are ultimately to be sold to customers in Germany.
- The automobiles are sold by Company A to its distribution subsidiary in Germany, Company B. Company B resells the automobiles to independent dealers.
- The automobiles cost € 10,000 per unit to develop and build.
- The customers pay € 20,000 for the automobiles at retail.
- The independent dealers earn gross profit of 15% of the end sale price or € 3,000 per automobile. That is, they buy automobiles from Company B at a price of € 17,000 per unit.
- That leaves € 7,000 (20,000 – 3,000 – 10,000) to cover freight, selling / marketing costs, and overhead costs, to fund development of new car models and technology, and to provide profit for Company A and Company B.

QUESTIONS

- How much should should Company A charge Company B for the automobiles?
  a. € 9,000
  b. € 10,500
  c. € 13,000
  d. € 15,000
  e. € 17,000
  f. Cannot tell based on the information presented

QUESTIONS

- What additional facts do you need to know in order to identify an arm's length price?
  a. Profit margins of other manufacturers?
  b. Company B's distribution costs?
  c. Per unit freight costs from Japan to Germany?
  d. Retail prices charged by competing companies for their cars?
  e. Prices charged selling similar cars to unrelated dealers in Japan?
  f. Company A's total investment in manufacturing plant and equipment?
  g. Whether Company A uses the same brand in Japan and Germany?
  h. Anything else?

QUESTIONS

- What are the tax consequences of any possible answer to the question of what is the right price?
  - For Japan
  - For Germany
  - For the automobile company

WHAT IS TRANSFER PRICING

UN Practical Manual Para 1.1.6.

"Transfer pricing is the general term for the pricing of cross-border, intra-firm transactions between related parties. Transfer pricing … refers to the setting of prices for transactions between associated enterprises involving the transfer of property or services."

KEY TERMS IN THE DEFINITION

- Cross-border
- Transactions
- Between "related" parties or "associated enterprises"

EXAMPLES OF TRANSACTIONS REQUIRING TRANSFER PRICING ANALYSIS

- Sales of tangible goods including finished inventory, parts and components, and commodity products.
- Provision of services including corporate administration, sales and marketing, research, other technical services, etc.
- Transfers of intangibles including rights to use patents, trademarks, brands, technical know-how, etc.
- Financial transactions including loans, financial guarantees, performance guarantees, related party insurance arrangements, derivatives.
- Etc., etc., etc.

- Intra – group transactions constitute at least 30 percent of global trade.

WORDS NOT FOUND IN THE DEFINITION

- Profit shifting
- Manipulation
- Transfer mispricing
- Tax avoidance

- **Key concept: Transfer pricing is a normal part of international commerce. While companies can, and sometimes do, manipulate related party prices for tax advantage, tax authorities need to be concerned about whether the right prices are charged even where intentional, tax motivated price manipulation is not present.**

OBJECTIVES OF A TRANSFER PRICING ANALYSIS

- Determine the proper prices for transactions between associated enterprises.
- Make sure that the resulting allocation of income between taxing jurisdictions reflects the underlying economic activity.
- Reach cross border agreements on proper pricing among the taxpayer and the affected countries.
- Avoid double taxation.

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The Arm's Length Principle

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ARM'S LENGTH PRINCIPLE

- Stated most simply, the arm's length principle requires the prices and other conditions of transactions between associated enterprises (related parties) to be the same as the prices and other conditions that would be established in comparable transactions between independent enterprises (unrelated parties).

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RATIONALE FOR APPLYING THE ARM'S LENGTH PRINCIPLE

- The rationale for the arm's length principle is that because markets govern transactions between unrelated parties, determination of prices for related party transactions on the basis of the prices charged or margins earned in comparable unrelated party transactions will assure a market based allocation of income between the related parties.

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CENTRAL ROLE OF THE ARM'S LENGTH PRINCIPLE

- The arm's length principle is the generally accepted guiding principle used in establishing acceptable transfer prices.
- The transfer pricing rules in nearly all countries are based on the arm's length principle.
- Nearly all bilateral tax treaties commit countries to follow the arm's length principle. Article 9 of both the UN and OECD Model Treaties incorporates the arm's length principle.
- Consistent application of the arm's length principle across countries makes it possible to resolve transfer pricing disputes and to avoid double taxation – The need to resolve disputes makes it important to have a single set of rules.

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UN AND OECD MODEL ARTICLE 9 (1)

1. Where:

(*a*) an enterprise of a Contracting State <u>participates directly or indirectly</u> in the management, control or capital of an enterprise of the other Contracting State, or

(*b*) the <u>same persons participate directly or indirectly in the management, control or capital of an enterprise</u> of a Contracting State and an enterprise of the other Contracting State,

and in either case <u>conditions</u> are made or imposed between the two enterprises in their <u>commercial or financial relations which differ from those which would be made between independent enterprises</u>, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, <u>by reason of those conditions</u>, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

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SOURCES OF GUIDANCE ON THE ALP

- The UN Practical Manual on Transfer Pricing for Developing Countries, first published in 2012 and expanded and updated in 2017. The UN manual provides practical advice on applying the arm's length principle in many situations relevant to developing countries.
- The OECD Transfer Pricing Guidelines (updated in 2017) provide detailed guidance on applying the arm's length principle. They are accepted and followed by most countries and they are routinely used in resolving cross border transfer pricing disputes.
- The UN Manual and the OECD Guidelines are generally consistent.
- There are also numerous decided court cases from countries around the world that apply the ALP.

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Conducting a Transfer Pricing Analysis

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APPLYING THE ARM'S LENGTH PRINCIPLE

- Transfer pricing under the arm's length principle is based on comparing controlled transactions to uncontrolled transactions.
- There are three key steps in a transfer pricing analysis:
  - Get the relevant facts – functional analysis;
  - Identify useful comparable transactions or relationships – comparability analysis;
  - Select and apply the most appropriate transfer pricing method.

FUNCTIONAL ANALYSIS

- A functional analysis is the process used to assemble the economically relevant facts for a transfer pricing analysis.
- Key elements of the functional analysis may include:
  - Understanding the overall process by which the MNE creates value and the key factors contributing to value creation in its global business.
  - Identifying the relevant cross border transactions between associated enterprises.
  - Identifying the specific terms of those transactions by reference to written contracts and the actual conduct of the parties.
  - Identifying specifically the functions performed, assets used, and risks assumed by each of the parties in relation to the identified transactions – **Accurately Delineating the Transaction**.

SOURCES OF INFORMATION ON TAXPAYERS' TRANSACTIONS

- Written contracts, invoices, payments, etc.
- Conduct of parties
  - What did they actually do
  - Was it consistent with the contracts
  - Are there activities undertaken or risks assumed not covered by the contracts
  - Are functions assigned to a party under the contract which that party lacks the capability to perform

COMPARABLES

- Application of the arm's length principle is usually based on a comparison of the conditions of a controlled transaction with the conditions of transactions between independent enterprises
- The comparison is only useful if the economically relevant circumstances of the controlled and uncontrolled transactions being compared are sufficiently similar, i.e. if they are in fact **comparable**
- **To be comparable means that none of the differences between the situations being compared could materially affect the price for the transaction, or if material differences do exist, reasonably accurate adjustments can be made to eliminate the effect of such differences on prices.**

COMPARABILITY FACTORS

- The relevant factors to consider in evaluating comparability include:
  - —characteristics of the goods or services in question
  - —comparability of the functions performed by each of the parties
  - —terms of the transactions being compared
  - —nature and of the risks assumed by each of the parties
  - —economic circumstances of the parties
  - —business strategies followed by the parties

COMPARABILITY ADJUSTMENTS

- In some situations comparability adjustments should be considered in order to improve the reliability of the transfer pricing analysis
- Comparability adjustments should be considered only if the adjustment will increase the reliability of the results
- Depending on the transfer pricing method being used, common comparability adjustments include adjustments for financing costs, payment terms, and specific differences in other contract terms (e.g. delivery, freight, etc.)
- Adjustments for country and market differences, currency exchange movements, different levels of risk, purchase volumes, and similar items can be far more difficult to calculate on a reliable basis

TRANSFER PRICING METHODS

- Transfer pricing methods are used to determine appropriate transfer prices and profits from controlled transactions
- The selection of the most appropriate transfer pricing method depends on the factual / functional analysis and on the availability of information on comparables
- The most appropriate transfer pricing method is that method that will most reliably lead to the identification of an arm's length price, given the relevant facts and the availability of relevant data.
- There are 5 specified transfer pricing methods

SELECTING THE TESTED PARTY

- The general practice is to select the less complex party as the tested party.
- It is usually quite difficult to treat an entity that owns important intangibles as the tested party in applying a one-sided transfer pricing method.
- It is important in applying one-sided methods to make sure that the functional analysis also considers the functions performed, assets used, and risks assumed on the other side of the transaction.

REVIEW – A NINE STEP PROCESS FOR CONDUCTING A TRANSFER PRICING ANALYSIS

1. Determine years covered
2. Broad analysis of taxpayer's circumstances
3. Understand the controlled transactions
4. Review existing internal comparables, if any
5. Identify sources of possible external comparables
6. Select the most appropriate transfer pricing method
7. Identify potential comparables
8. Make comparability adjustments if necessary
9. Interpret relevant data and determine arm's length prices

PRINCIPLES TO REMEMBER

- Transfer pricing is not a science – there may not be a single correct arm's length price for a specific transactions.
- Instead, there will often be a range of reasonable arm's length outcomes. Where a taxpayer's reported pricing is within that reasonable range, transfer pricing adjustment generally should not be made.
- But – outcomes should not consistently be at either the top end of the bottom end of the reasonable range.
- Tax administrations may wish to focus their attention on larger transactions with material amounts of tax at stake, particularly where there is evidence of a good faith effort to comply with the arm's length principle.

The Legal Environment

OVERVIEW

- Domestic transfer pricing legislation
- Principles and obligations under tax treaties
- Burden of proof
- Safe harbour rules
- Advance pricing agreements
- Dispute resolution

DOMESTIC LEGISLATION

UN Practical Manual Paras. 3.2.2. – 3.2.6.

- Many countries have enacted domestic transfer pricing rules
- In most countries transfer pricing rules are based on the arm's length principle
- Domestic transfer pricing law varies
  - The transfer pricing law may be included in legislation, or
  - The legislation may express the main principles with definitions and examples included in subordinate legislation such as regulations

DOMESTIC LEGISLATION

UN Practical Manual Para. 3.2.6.

- Domestic legislation may include
  - The definition of associated enterprises
  - Transfer pricing methodologies
  - Documentation requirements
  - Penalties
  - Procedures for Advance Pricing Agreements
  - Rules related to the burden of proof

TAX TREATIES

- Tax treaties often include provisions regarding transfer pricing
- Article 9(1) permits adjustments to taxpayer income when the conditions of transactions between associated enterprises differ from those that would be found between independent enterprises
- Tax treaties also often contain provisions requiring relief of double taxation when transfer pricing adjustments are made and provisions establishing international dispute resolution mechanisms
- The UN Practical Manual on Transfer Pricing and the OECD Transfer Pricing Guidelines contain guidance on applying these treaty provisions

BURDEN OF PROOF

UN Practical Manual Paras. 3.6.1. – 3.6.3.

- A country's domestic law will place the burden of proof in tax cases on either the MNE or the tax authority
  - The MNE may have to prove that its transfer prices are consistent with the arm's length principle
  - Alternatively the tax authority may have to prove that a taxpayer's transfer prices are inconsistent with the arm's length principle

SAFE HARBOUR RULES

UN Practical Manual Para. 3.8.1. – 3.8.8.

- As it may be costly to determine transfer prices for controlled transactions, a practical alternative is to provide taxpayers with the option of using a safe harbour for certain transactions

- The safe harbour rules are estimates of arm's length prices

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SAFE HARBOUR RULES

- Safe harbours provide taxpayers with the benefit of certainty and reduced compliance costs

- Safe harbours provide tax authorities with the opportunity to reduce the cost of administering transfer pricing rules and enable them to focus their efforts on important transfer pricing cases

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SAFE HARBOUR RULES

- There are some disadvantages of providing safe harbour options

  - There is a risk that some taxpayers may abuse a safe harbour by reorganizing transactions to fit within the set safe harbour limits

  - The safe harbours may be too generous

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ADVANCE PRICING AGREEMENTS

Paras. 3.10.1. – 3.11.6.

- Advance Pricing Agreements (APAs) are an agreement between a taxpayer and a tax authority on transfer prices for controlled transactions
- APAs may be unilateral, bilateral or multilateral
  - A unilateral APA may result in economic double taxation if the other tax authority disagrees with approach taken in an APA
  - The cost and time in establishing a bilateral APA may be substantial
- The advantage of obtaining an APA is that a taxpayer is provided with certainty provided it complies with the APA

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ADVANCE PRICING AGREEMENTS

UN Practical Manual Para. 3.10.2.

- The advantages that APAs provide for developing countries are
  - That some MNEs have global transfer pricing policies which may allow developing countries to obtain existing documentation
  - If an MNE has APAs with other countries, these may provide the basis for a developing country concluding an APA
  - A unilateral APA with one jurisdiction may form the basis for an APA with the other jurisdiction

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ADVANCE PRICING AGREEMENTS

UN Practical Manual Para. 3.10.3.

- Some countries may choose to delay the use of APAs
  - A tax authority may prefer to develop its transfer pricing capability in order to be able to evaluate APA applications
  - The taxpayers seeking APAs may be low risk taxpayers resulting in resources being diverted from high risk transfer pricing cases
- Monitoring of APAs is required to make sure that the APA process is consistently applied and is not subject to abuse

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DISPUTE RESOLUTION

UN Practical Manual Para. 3.11.1 – 3.11.6.

➢Chapter 9 of the Manual and the fifth day of this course deal with dispute avoidance and resolution

➢A transfer pricing adjustment by one country will result in economic double taxation if the other country does not provide a corresponding adjustment

- Developing countries should consider dispute resolution mechanisms when designing a transfer pricing system
- Domestic dispute resolution mechanisms and
- The mutual agreement procedure under Article 25 of the UN Model tax treaties

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DISPUTE RESOLUTION

- The mutual agreement procedure under Article 25 of the UN Model Convention requires the competent authorities of the treaty countries to endeavour to resolve the dispute by mutual agreement if the objection is justified
- Competent authorities from developing countries may be inexperienced in negotiating transfer pricing cases with the competent authority from the other country

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Course Overview

COURSE OVERVIEW

1. Introduction
2. Transfer Pricing Documentation
3. Audits and Risk Assessment
4. Comparability Toolkit
5. Intra-group Services
6. Transactions Involving Intangibles
7. Cost Contribution Arrangements
8. Establishing TP Capability in Developing Countries
9. Dispute Avoidance and Resolution