Introduction to Transfer Pricing

Presented by Ziad Rahman
APTP

Agenda

- What is Transfer Pricing?
- Arm's Length Principle.
- Transfer Pricing Documentation.
- Transfer Pricing Methodologies.
- Benchmarking.
- Transfer Pricing trends and observations in the Asia Pacific.
- Questions?

What is Transfer Pricing?

IP and knowhow owned

The $500 is shared between the three parties for the functions performed, assets utilised and risk assumed.

For example:

$50 – selling the phone

$50 – assembling the phone

$400 – for owning the IP and developing the phone

Phone assembled

Phone sold to you for $500

Example Only

An Example of the impact of Transfer Pricing

	Country A	Country B	Country C
Sales	500	450	400
COGS	450	400	150
GM	50	50	250
Operating Expense	25	10	50
Profit/Taxable income	25	40	200
Tax	6.88 (@27.5%)	10 (@25%)	80 (@40%)

Example Only

An Example of the impact of Transfer Pricing

	Country A	Country B	Country C
Sales	500	450	300
COGS	450	300	150
GM	50	150	150
Operating Expense	25	10	50
Profit/Taxable income	25	140	100
Tax	6.88 (@27.5%)	35 (@25%)	40 (@40%)

Example Only

Arm's Length Principle

- Transfer Pricing rules are based on the guidelines established by the OECD (OECD Guidelines).
- Countries that have Transfer Pricing rules require that cross-border related party transactions are undertaken in a manner that is consistent with the arm's length principle.
- Arm's length principle is:
  - Related party transaction(s) should be undertaken in a manner that would be consistent to how the transaction would have taken place had the transaction taken place with an independent third party.
  - So how to prove that a transaction with a related party has taken place in an arm's length manner: Transfer Pricing documentation.

What is Transfer Pricing Documentation

- Six main parts:
  - Background Information;
  - Functional Analysis;
  - Industry Analysis;
  - Selection of most appropriate transfer pricing method;
  - Economic/benchmarking analysis; and
  - Conclusion/Findings.

Background information

- Details of the multinational group.
- Main source of income.
- Organisational chart.
- Related party transaction(s).

Functional Analysis

- A story of the related party transaction(s) taking three key aspect into consideration:
  - Functions performed:
    - What function was performed and how did it benefit or generate revenue for the related party.
  - Assets used in performing the function:
    - What assets were used in performing the related party transaction:
      - Human assets;
      - Manufacturing knowhow;
      - IP knowhow or secret knowledge.
  - Risk(s) assumed in performing the function:
    - Not always easily quantified.

Industry Analysis

- Factors that impact the business operations:
  - Broad economic factors that may impact the business operations and the related party transaction(s).
  - Other factors:
    - Market position;
    - Level of competition; and
    - Industry diversification.
  - Specific factors that impacted the business performance of an entity.
    - For example local country factors.

Selection of most appropriate Transfer Pricing Methodology

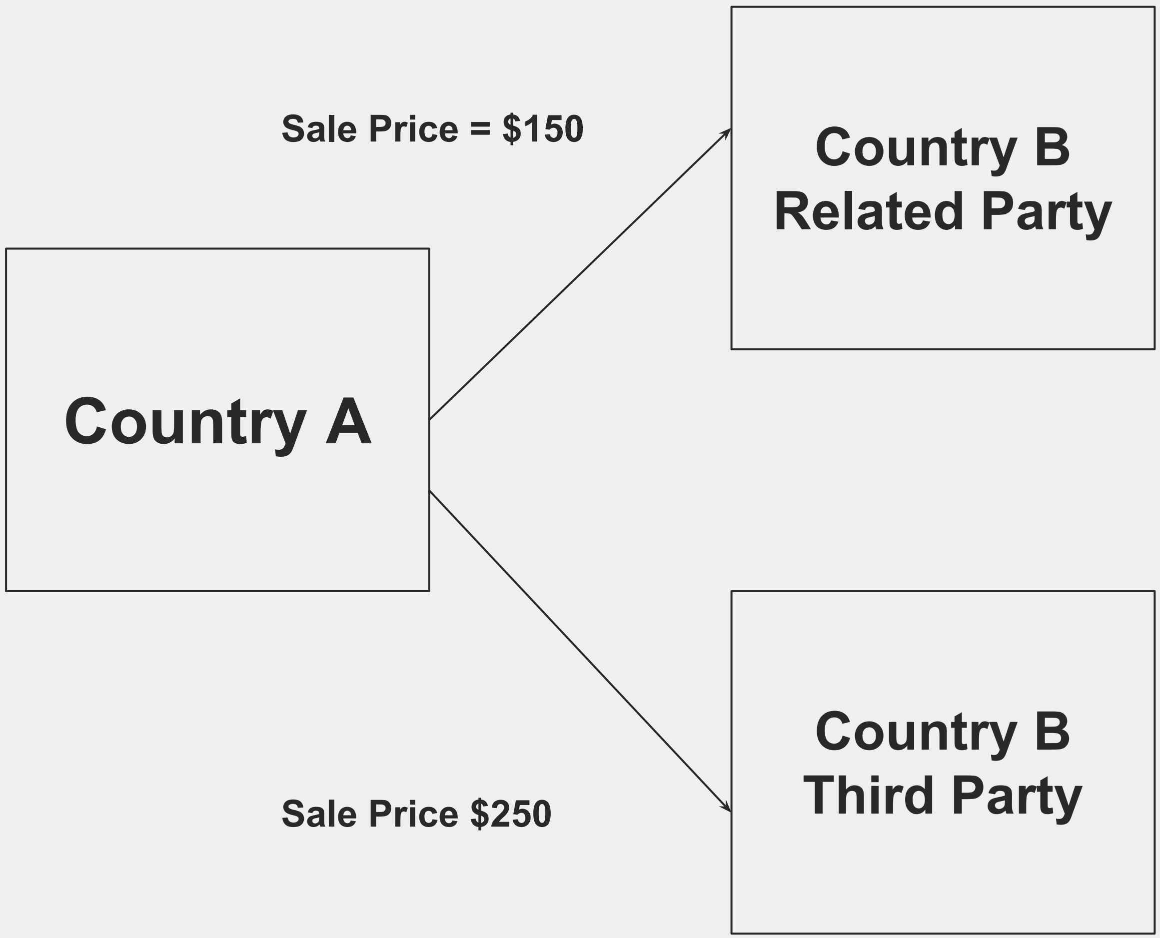
- Five transfer pricing methodologies are suggested by OECD Guidelines and are divided into two groups:
  - Traditional transaction methods’, (Traditional methods’) which comprise of:
    - The comparable uncontrolled price (CUP) method;
    - The resale price (RP) method; and
    - The cost plus (CP) method.
  - The transactional profit methods, (Profit methods) which comprise of:
    - The transactional net margin method (TNMM); and
    - Profit split.

Selection of most appropriate Transfer Pricing Methodology (continued)

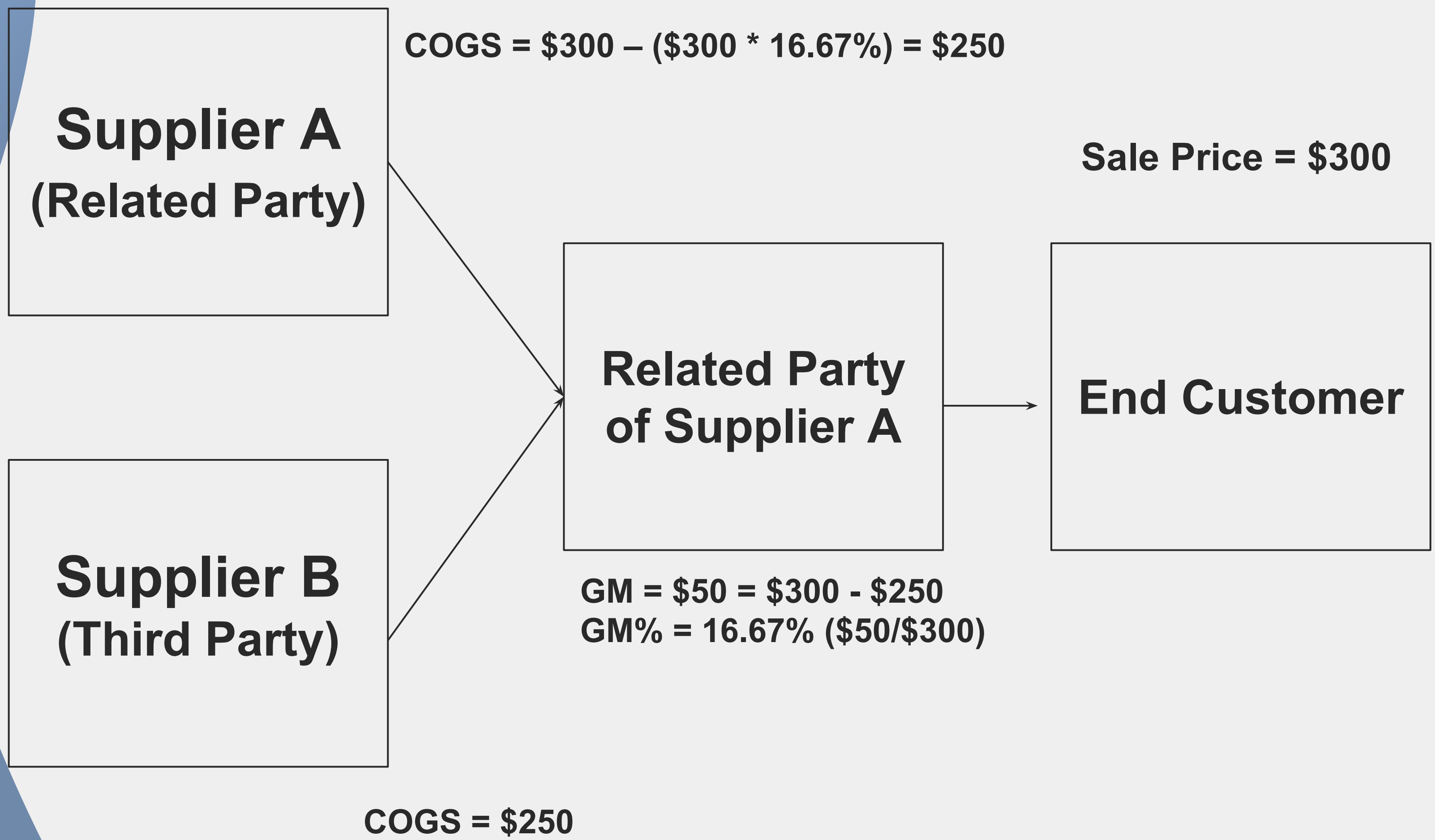
- Selection of the most appropriate Transfer Pricing methodology is dependent on:
  - Selection of the “tested party”; and
  - the availability of comparable transaction(s)/data.

- Two types of comparable data:
  - Internal comparables; and
  - External comparables.

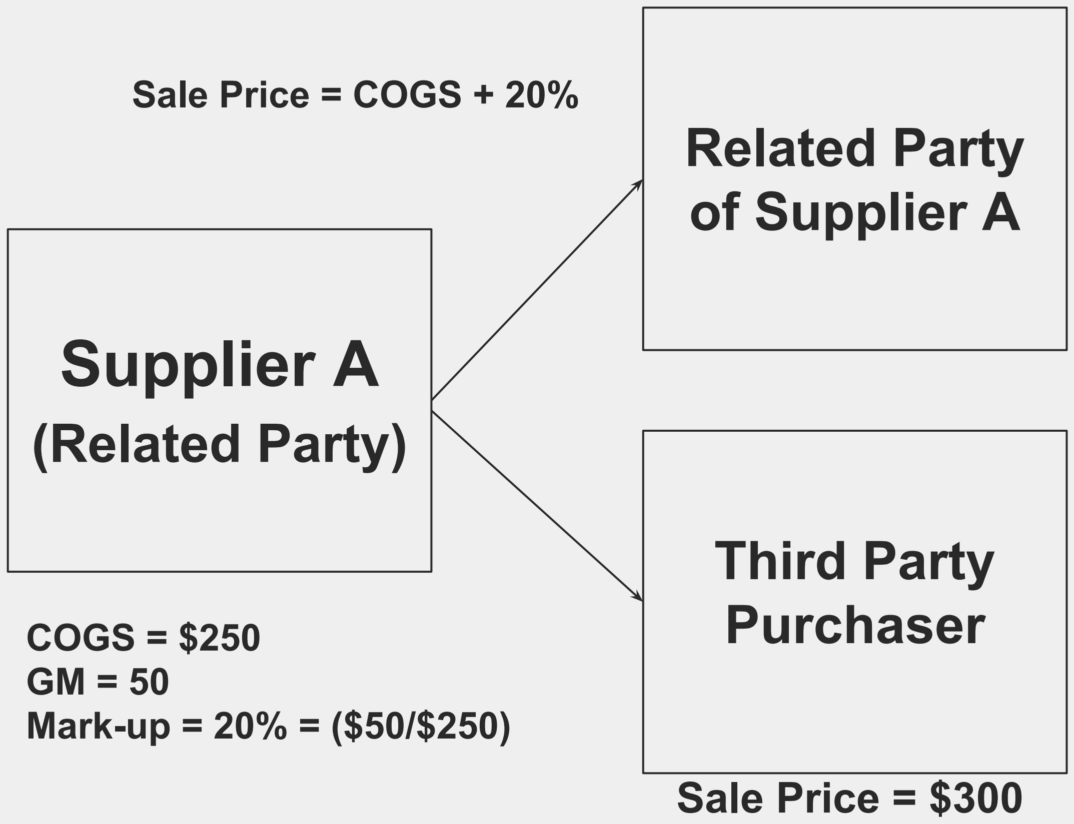
Comparable Uncontrolled Price (CUP)



Resale Price (RP)



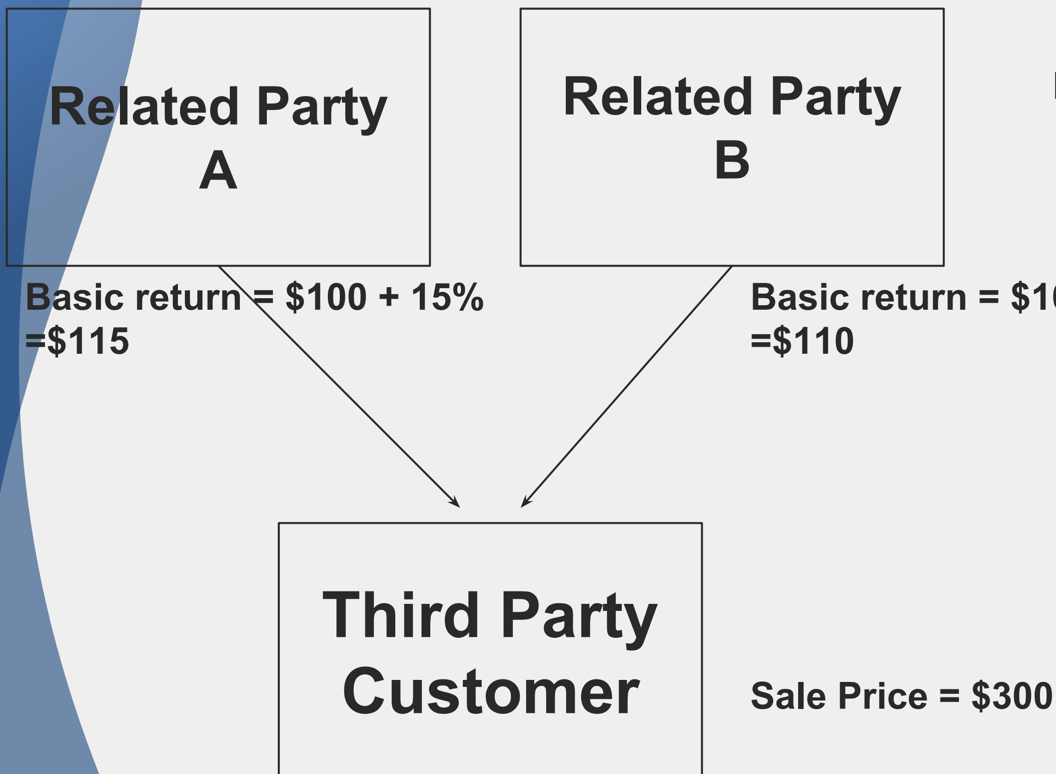
Cost Plus (CP) method.



Transactional Net Margin Method (TNMM)

- TNMM focuses on the net profit earned in the related party transaction compared to the net profit margin earned by comparable independent third party.
- Analysis is performed based on Profit Level Indicators (PLI).
  - Operating Margin – EBIT/Sales
    - Appropriate for resales and distribution functions
  - Net Cost Plus – EBIT/Total Operating Expense
    - Appropriate for service or manufacturing activity
  - Berry Ratio – Gross Margin/Operating Expense
    - Appropriate for intermediary activities
  - Return on Assets – EBIT/Total Assets or EBIT/Total Operating Assets
    - Appropriate for capital intensive activities such as manufacturing or utilities

Profit split – Residual analysis

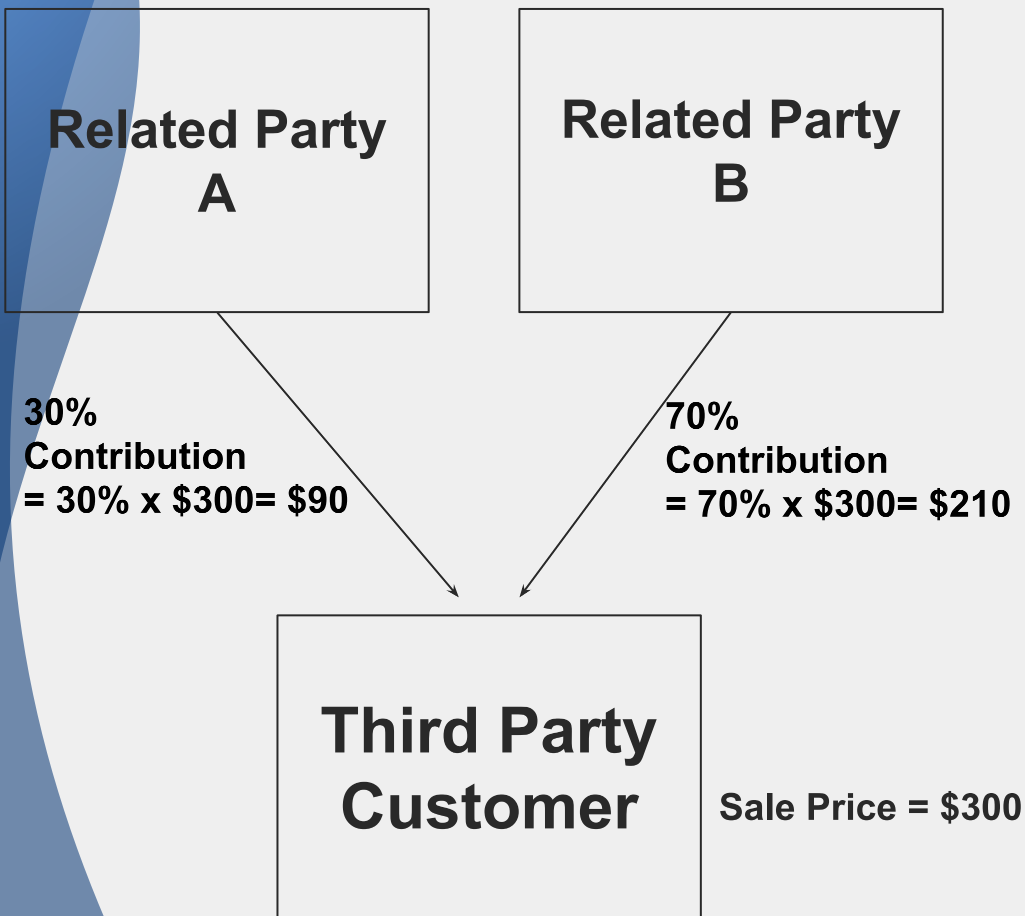


Residual profit = $300 – ($110 + $115)
= $75

Bases of splitting the residual profit can include:

- contribution of the intangible property;
- relative bargaining position; or
- how independent parties would have divided such residual profits in similar circumstances.

Profit split – Contribution analysis



Bases of splitting is based on the contribution to the overall integrated related party transaction.

The contribution should be established based on the facts and circumstances of the integrated related party transaction and considering the:

- functions performed;
- assets used; and
- risks assumed.

by each of the related parties.

This analysis should be supplemented where possible with external market data that indicate how independent enterprises would have divided profits under similar facts and circumstances.

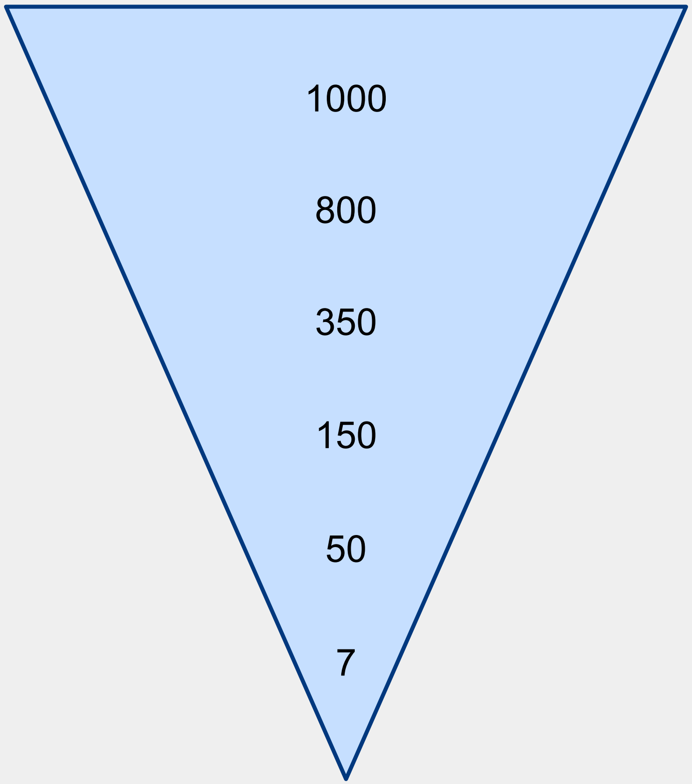
Benchmarking

External comparables are identified by using third party databases.
For example:

- Bureau Van Dijk (Osiris); or
- Thomson Reuters (Onesource).

- Selection criteria:
  - Standard Industry Code: (SIC).
  - Quantitative Screens.
  - Qualitative Screens.

- Time consuming process.



Benchmarking: Selection Criteria

Quantitative Screens	**No. of Companies**
Geographic Region	Australia
Primary Sic Codes	2773
No financial information	1487
Income less than a million	85
Private companies	930
Total number of companies after Quantitative Screens	271
Qualitative Screens	**No. of Companies**
Subsidiary	35
Not having at least year years of financial data from 2013,2012,2011	17
Functionally different	212
Final number of Comparables	7

Benchmarking Result

NCP	2013	2012	2011	2010	2009	2008	Weighted Average 2013 to 2009
Company A	-15.1%	16.3%	17.2%	16.2%	11.1%	14.4%	7.9%
Company B	2.4%	2.5%	3.3%	2.7%	2.7%	3.7%	2.7%
Company C	5.4%	4.5%	1.6%	0.7%	2.5%	5.0%	3.2%
Company D	8.2%	10.3%	11.0%	19.2%	13.2%	24.7%	12.4%
Company E	-8.3%	6.9%	6.6%	4.7%	15.0%	17.5%	4.7%
Company F	27.7%	30.1%	33.0%	38.7%	35.9%	42.0%	32.7%
Company G	5.2%	4.9%	3.3%	3.7%	3.8%	6.5%	4.1%
Min	-15.1%	2.5%	1.6%	0.7%	2.5%	3.7%	**2.7%**
1st Quartile	-3.0%	4.7%	3.3%	3.2%	3.2%	5.7%	**3.7%**
Median	5.2%	6.9%	6.6%	4.7%	11.1%	14.4%	**4.7%**
3rd Quartile	6.8%	13.3%	14.1%	17.7%	14.1%	21.1%	**10.2%**
Max	27.7%	30.1%	33.0%	38.7%	35.9%	42.0%	**32.7%**

Example Only

Managing Transfer Pricing risk

- Mutual Agreement Procedure (MAP).
  - Competent Authority (CA).
- Advance Pricing Arrangement (APA).

OECD - Action plan on Base Erosion and Profit Shifting (BEPS)

BEPS 15 Action points:

1. Address the tax challenges of the digital economy;
2. Neutralise the effects of hybrid mismatch arrangements;
3. Strengthen CFC (Controlled Foreign Corporation) rules;
4. Limit base erosion via interest deductions and other financial payments (TP);
5. Counter harmful tax practices more effectively, taking into account transparency and substance;
6. Prevent treaty abuse;
7. Prevent the artificial avoidance of PE status;
8. Intangibles (TP);
9. Risks and capital (TP);
10. Other high-risk transactions (TP);

OECD - Action plan on Base Erosion and Profit Shifting (BEPS) continued:

11. Establish methodologies to collect and analyse data on BEPS and the actions to address it;
12. Require taxpayers to disclose their aggressive tax planning arrangements;
13. Re-examine transfer pricing documentation (TP);
14. Make dispute resolution mechanisms more effective; and
15. Develop a multilateral instrument.

Questions?

Thank You

ziadrahman@aptp.com.co

www.aptp.com.co