

LLM Programme International and European Legal Studies
International and European Tax Law

Transfer pricing

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Tax planning

Case study

A Dutch company takes a loan of EUR 1,000,00 from a German company which belongs to the same multinational group. The intention of the Lender and the Borrower is that the loan is interest-free

The contracting parties request your professional opinion as to whether there are any tax obstacles

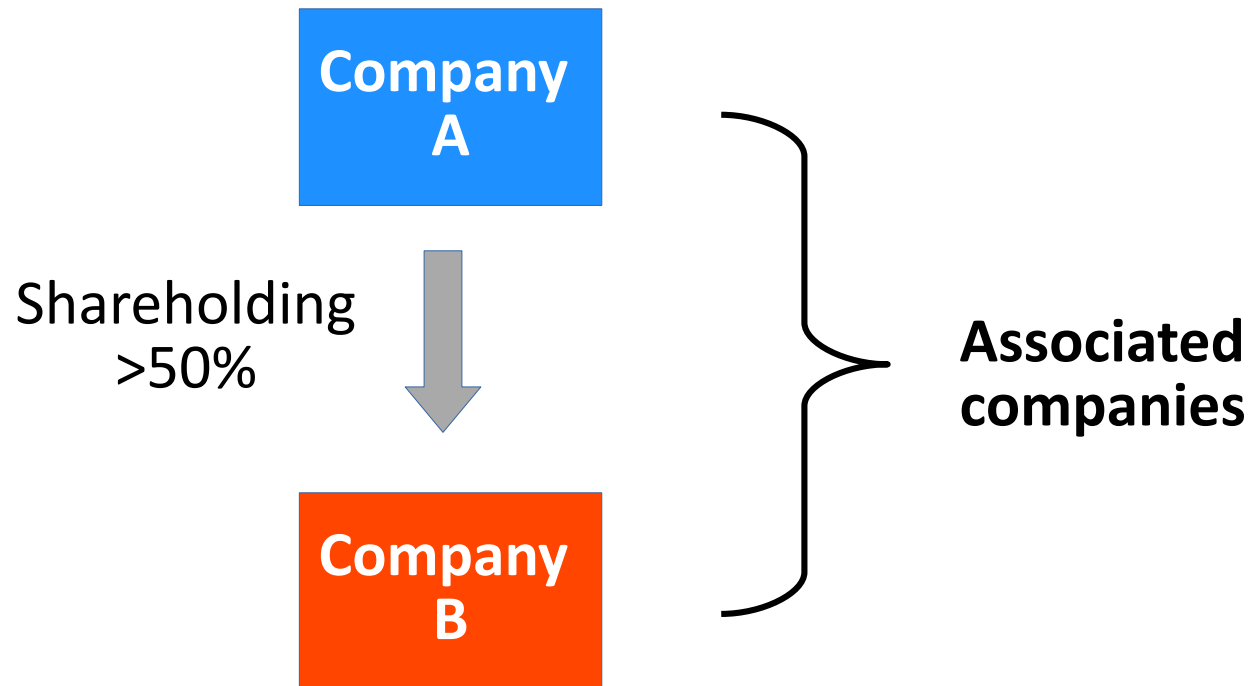
Transfer pricing

Terminology

- **Associated enterprises/companies:** Enterprises/companies under common control
 - ◆ Examples: affiliated companies, group of companies, companies with a common director or controlling shareholder,
- **Controlled transactions:** transactions between two enterprises that are associated with respect to each other
- **Uncontrolled transactions:** transactions between two enterprises that are independent from each other
- **Transfer price:** A transfer price is the price established in a transaction between related persons
- **Transfer pricing:** Transfer pricing is the area of tax law and economics that is concerned with ensuring that prices charged between associated enterprises for the transfer of goods, services and intangible property accord with the arm's length principle.

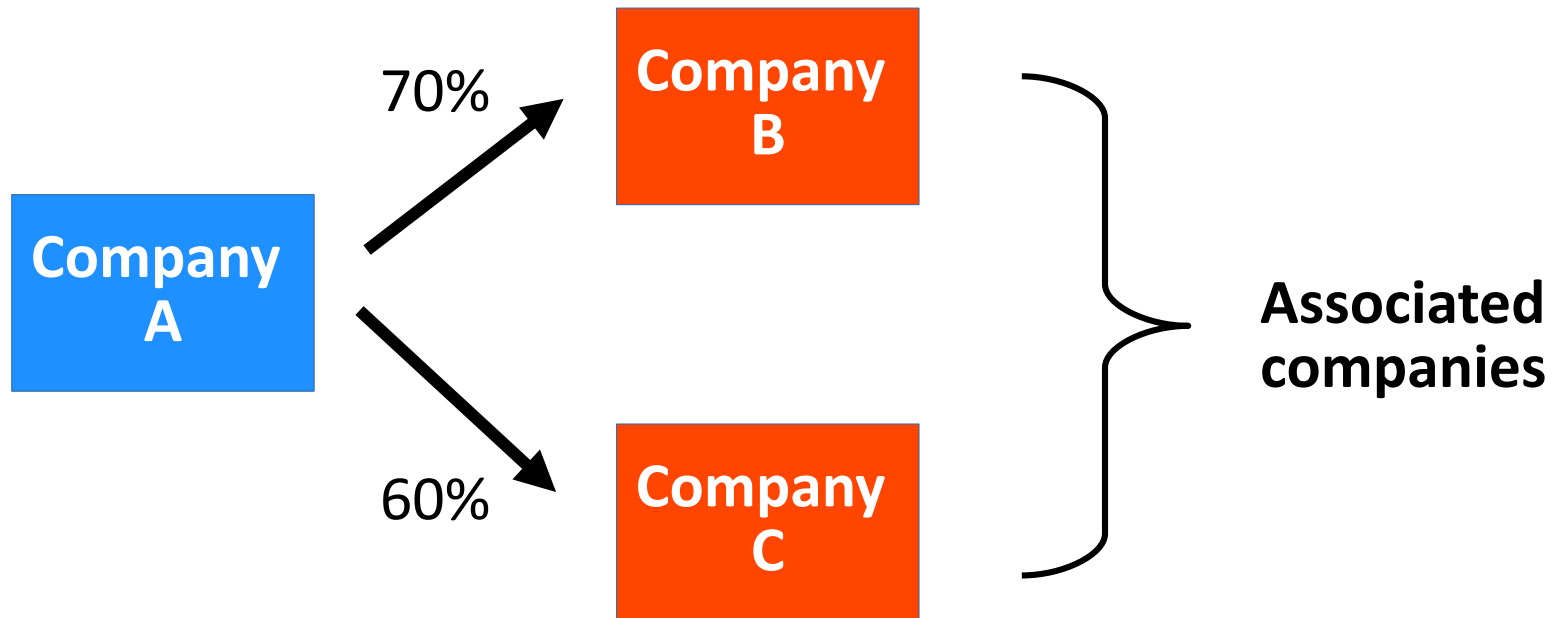
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Associated enterprises



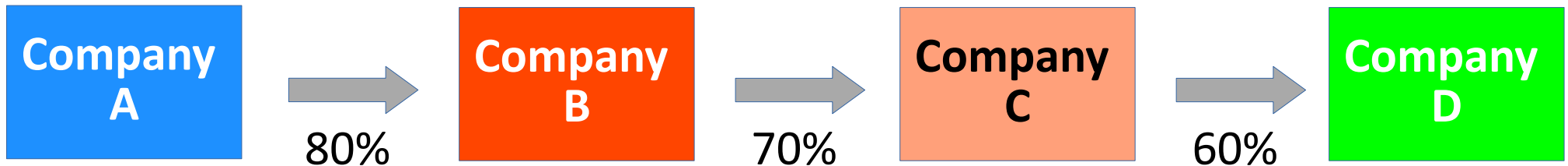
Transfer pricing

Associated enterprises



Transfer pricing

Associated enterprises



A → B: 80% (associated)

A → C: $80\% \times 70\% = 56\%$ (associated)

A → D: $80\% \times 70\% \times 60\% = 33,6\%$ (not associated)

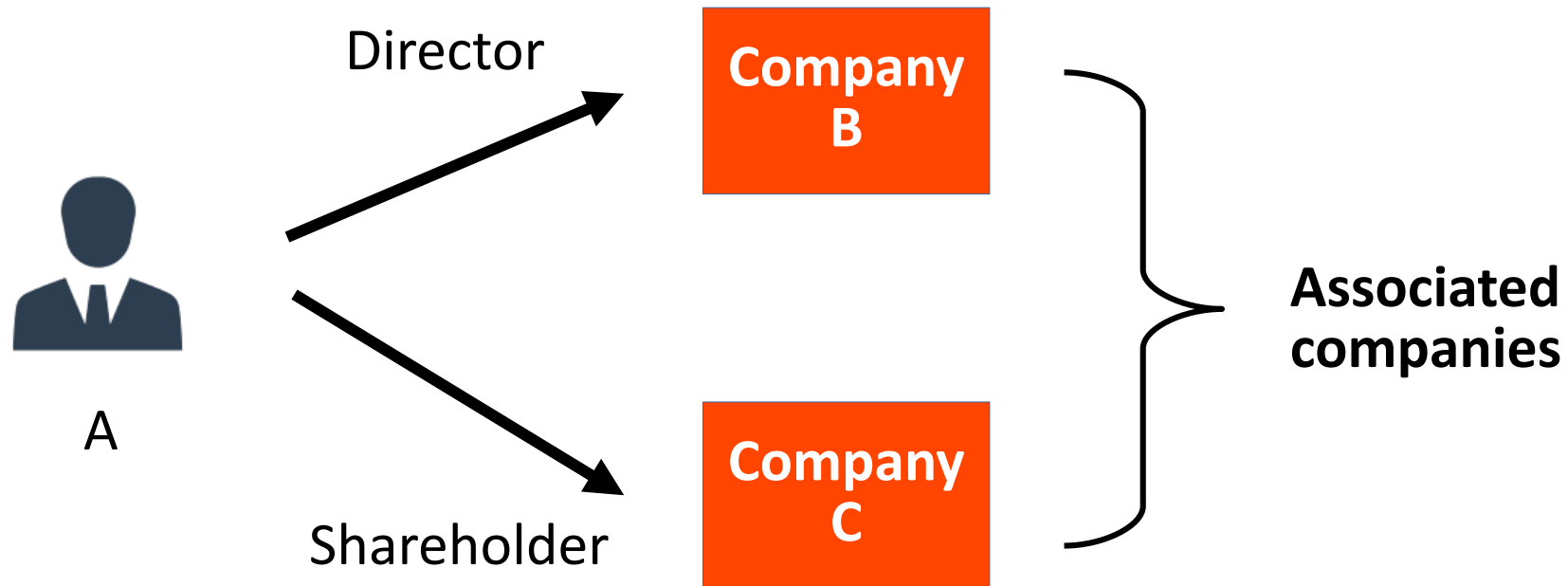
B → C: 60% (associated)

B → D: $70\% \times 70\% = 42\%$ (not associated)

C → D: 60% (associated)

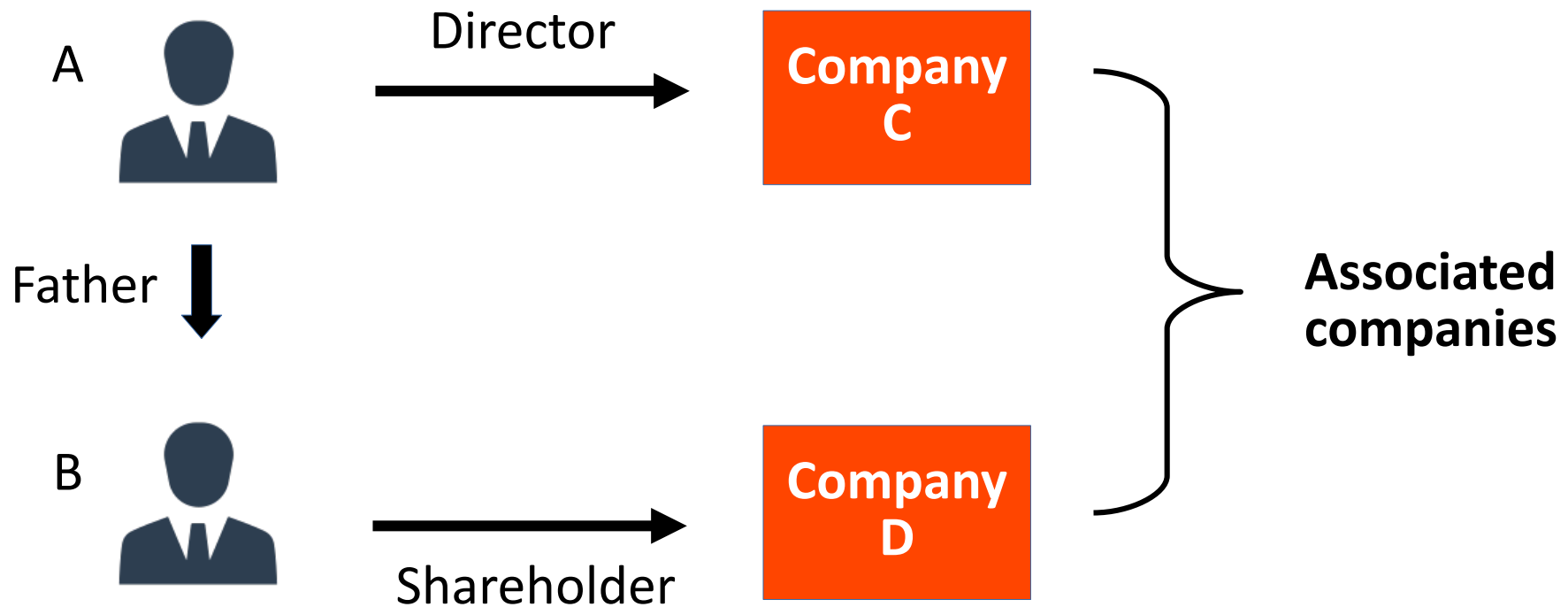
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Associated enterprises



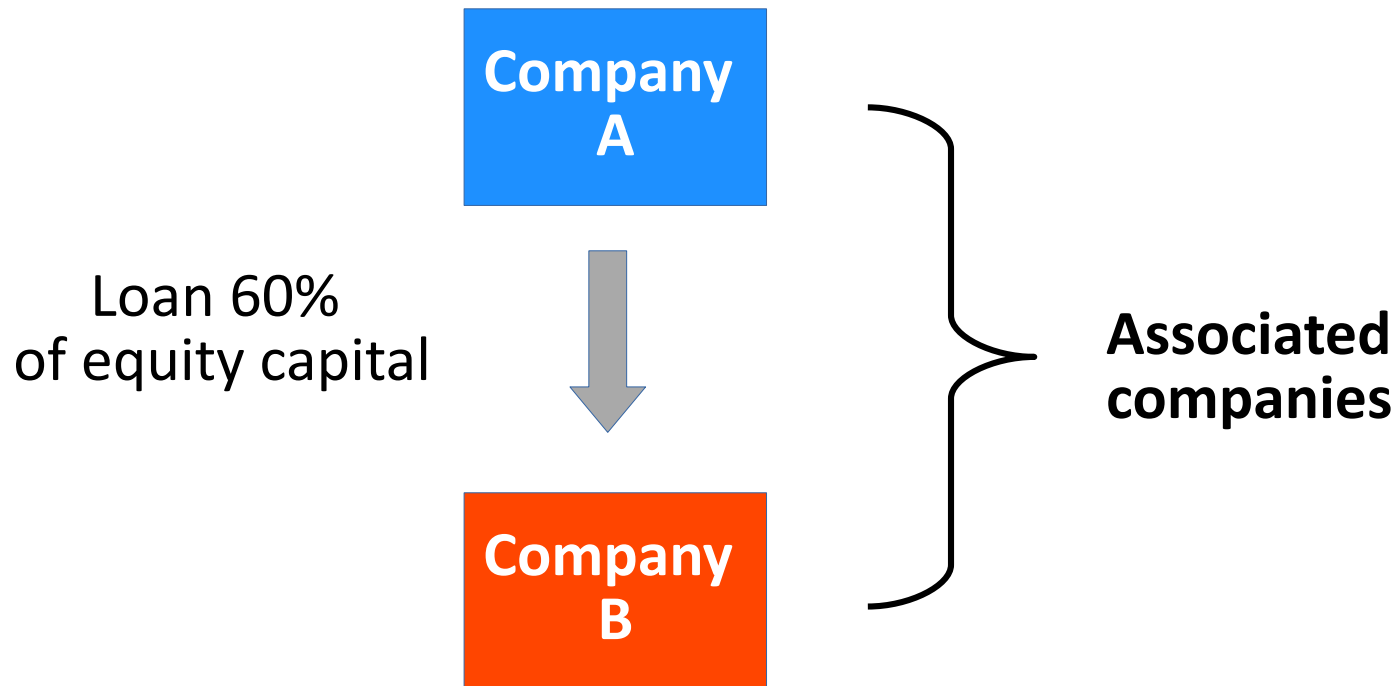
Transfer pricing

Associated enterprises



Transfer pricing

Associated enterprises



Transfer pricing

Concept

- The underlying problem
 - ◆ Controlled transactions may be arbitrarily priced (overpriced or underpriced)
 - ◆ Incorrect transfer pricing results in profit shifting

Transfer pricing

Cost 10.000 €

Sale 20.000 €

**Car
manufacturer**

15.000€

**Local
subsidiary**

20.000€

Consumer

Profit 5.000€
Tax 1.400€

Profit 5.000€
Tax 500€

Global tax 1.900€

**Car
manufacturer**

18.000€

**Local
subsidiary**

20.000€

Consumer

Profit 8.000€
Tax 2.240€

Profit 2.000€
Tax 200€

Global tax 2.440€

France

Tax rate 28%

Bulgaria

Tax rate 10%

Transfer pricing

Cost 10.000 €

Sale 20.000 €

**Car
manufacturer**

15.000€

**Local
subsidiary**

20.000€

Consumer

Profit 5.000€
Tax 1.400€

Profit 5.000€
Tax 500€

Global tax 1.900€

**Car
manufacturer**

12.000€

**Local
subsidiary**

20.000€

Consumer

Profit 2.000€
Tax 560€

Profit 8.000€
Tax 800€

Global tax 1.360€

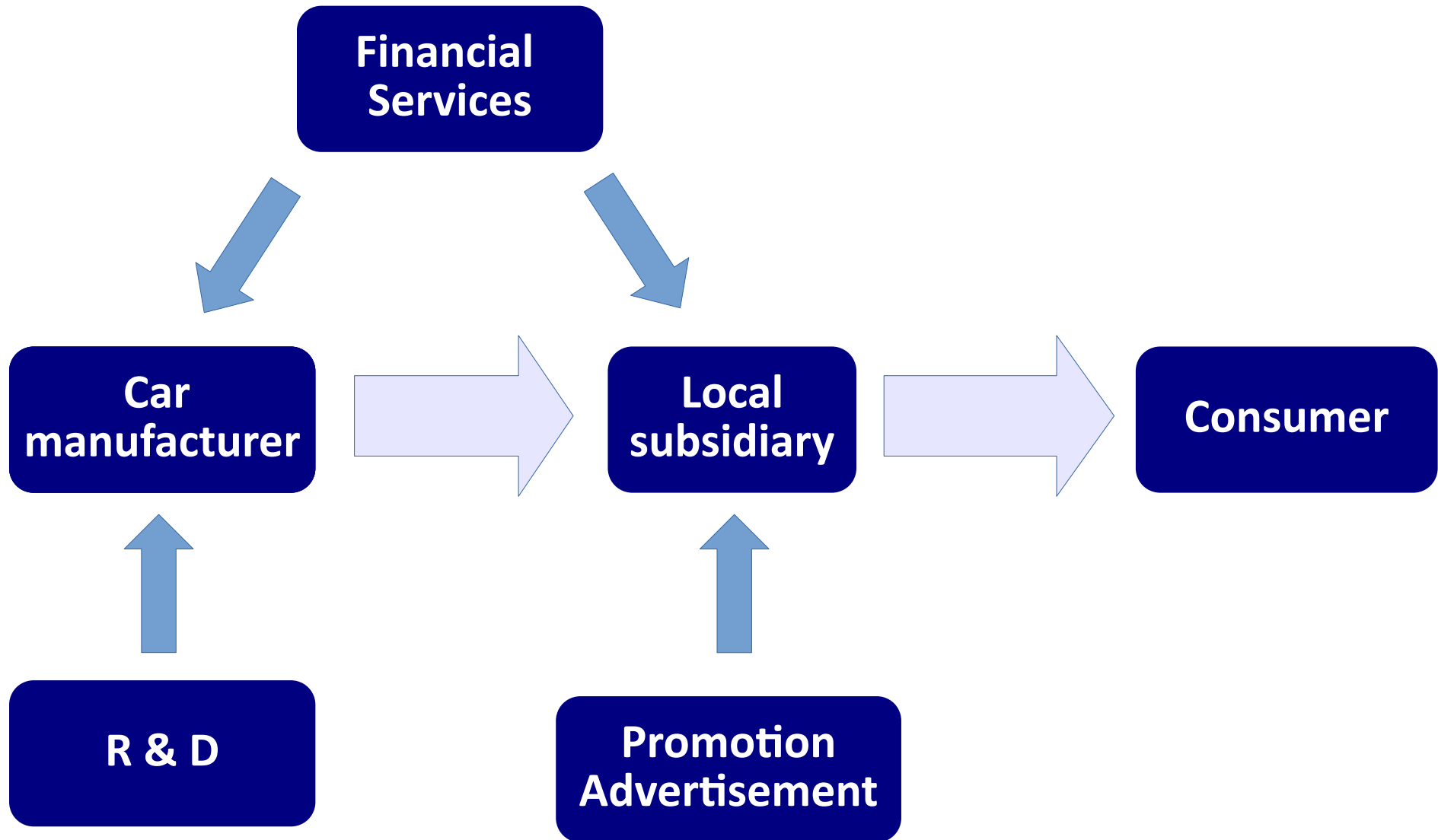
France

Tax rate 28%

Bulgaria

Tax rate 10%

Transfer pricing



Tax planning

Concept

- The underlying problem
 - ◆ If deliberate, incorrect transfer pricing may be used for tax avoidance purposes
 - ◆ Even if undeliberate, incorrect transfer pricing distorts taxation
 - ◆ Conflict of interest
 - Between states that seek to protect their taxing rights
 - Between taxpayers and states for correctly determining transfer prices

Tax planning

Concept

- Importance
 - ♦ It is estimated that about 60-70% of international trade happens within, rather than between, multinationals.
 - ♦ Transfer pricing is one of the most important issues in international tax.
 - ♦ Transfer pricing is one of the main areas of expertise for tax law professionals
 - ♦ “Transfer pricing is the leading edge of what is wrong with international tax” – Lee Sheppard, Tax Analysts, August 2012

Tax planning

Concept

- Solution: Two alternative approaches
 - ◆ Separate entity (bottom up)
 - Look at each entity separately and calculate its profit as if it were an independent entity.
 - ◆ Unitary taxation (top down)
 - Take the profit of the whole group and divide it between the individual entities.

Arm's Length Principle

- Separate entity principle
 - ◆ Currently the global norm
 - ◆ Based on Arm's Length Principle (ALP)
- Arm's length principle: It requires associated enterprises to charge the same prices, royalties and other fees in relation to a controlled transaction that would be charged by independent parties in an uncontrolled transaction in otherwise comparable circumstances.
- Arm's length price: transfer price in conformity with arm's length principle

Arm's length principle

- Theoretical background: OECD Transfer Pricing Guidelines
- Determination of arm's length price:
 - ◆ Comparability analysis (between controlled and uncontrolled transactions)
 - Assets
 - Functions
 - Risks
 - ◆ Application of an appropriate transfer pricing method
 - Transaction based methods
 - Comparable uncontrolled price (CUP) method
 - Resale price method
 - Cost plus method
 - Transactional profits-based methods
 - Transactional net margin method (TNMM)
 - Profit split method
 - Comparable profits method

Tax planning

Arm's length principle

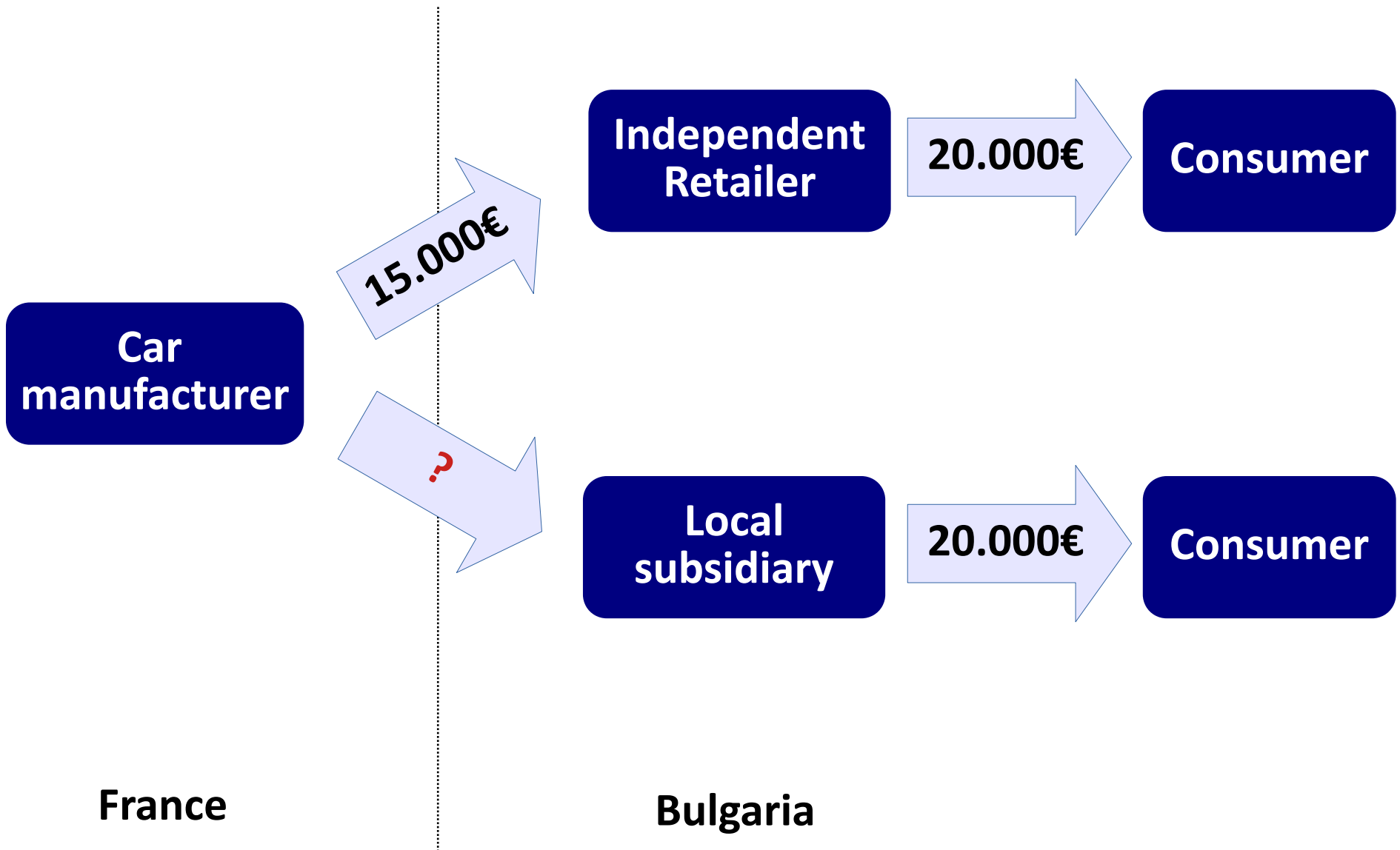
- Transfer pricing methods
 - ◆ Transaction based methods
 - Comparable uncontrolled price (CUP) method
 - Compare the intragroup price with the price of a comparable transaction between unrelated parties
 - Resale price method
 - Take the price charged by the reseller to the final consumer and deduct an appropriate gross margin
 - Cost plus method
 - Take the production cost and add an appropriate profit margin

Arm's length principle

- Transfer pricing methods
 - Transactional profits-based methods
 - Profit split method
 - ➔ Split the total profit earned on a transaction by all the group companies involved in it
 - Transactional net margin method (TNMM)
 - ➔ Compare net profit margins
 - ➔ Net profit: profit as a percentage of revenue
 - Comparable profits method
 - ➔ Compare operating profit margins
 - ➔ Operating profits: earnings before interest and tax (EBIT) compared to profits from sales

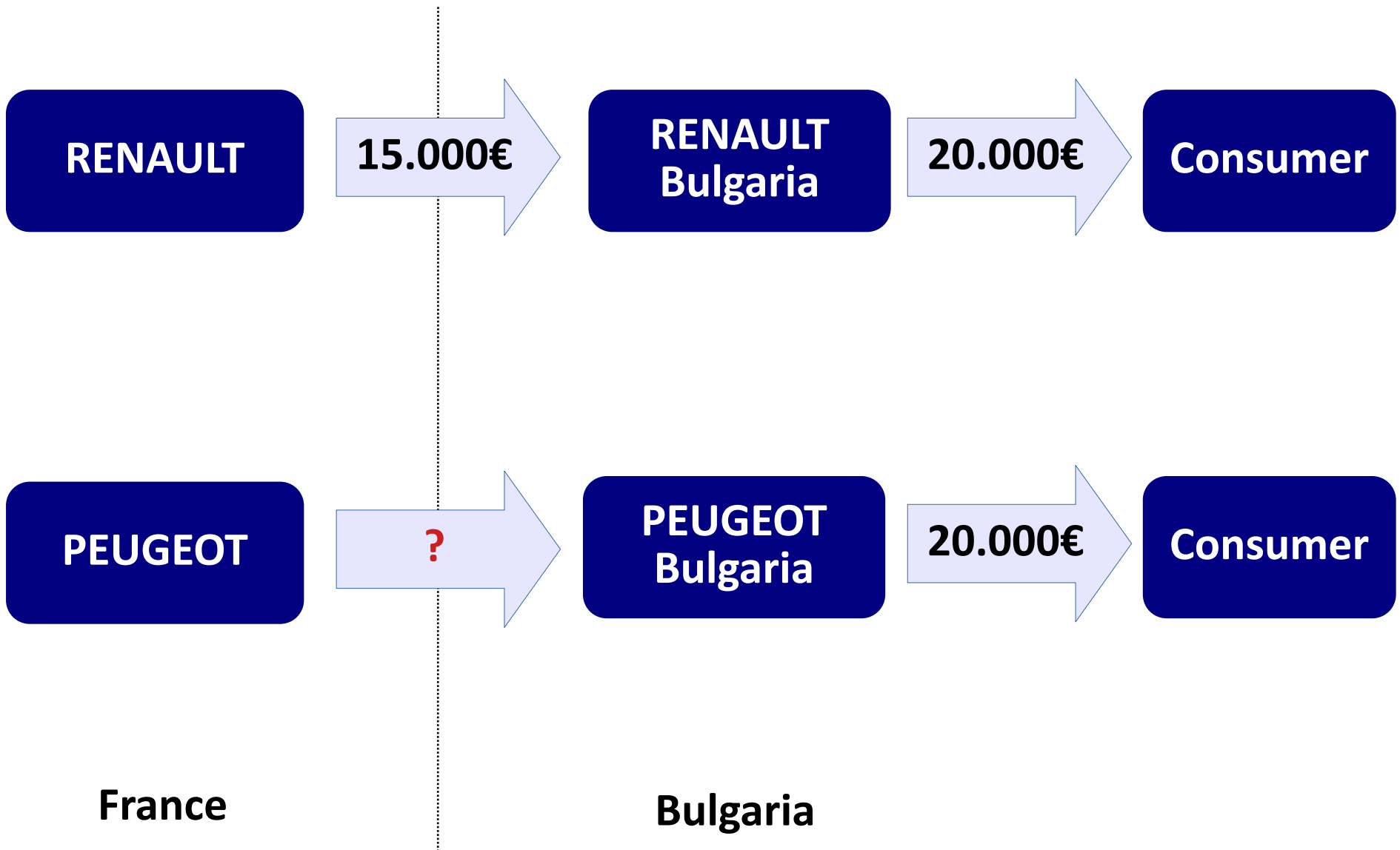
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Comparable Uncontrolled Price Method



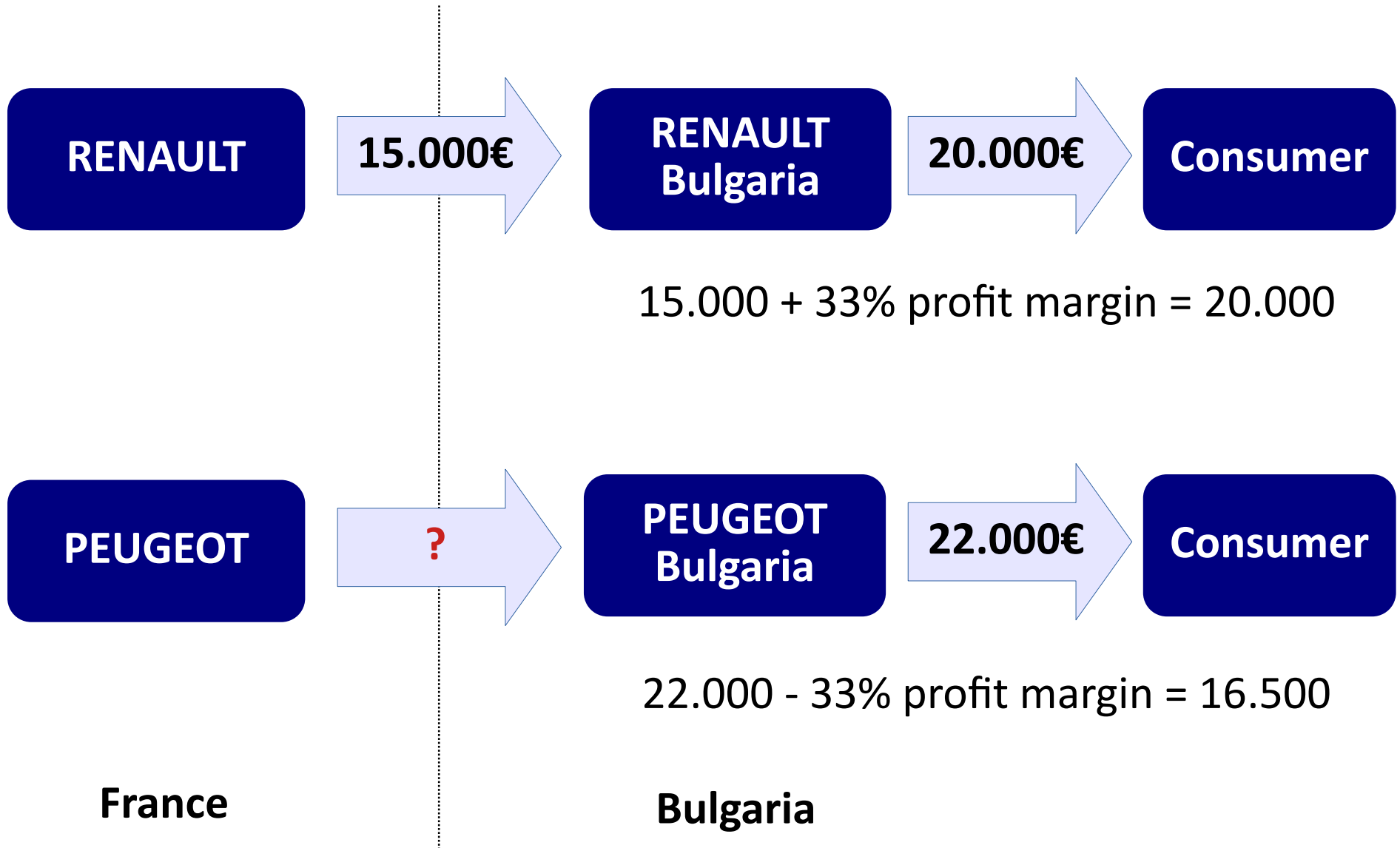
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Comparable Uncontrolled Price Method



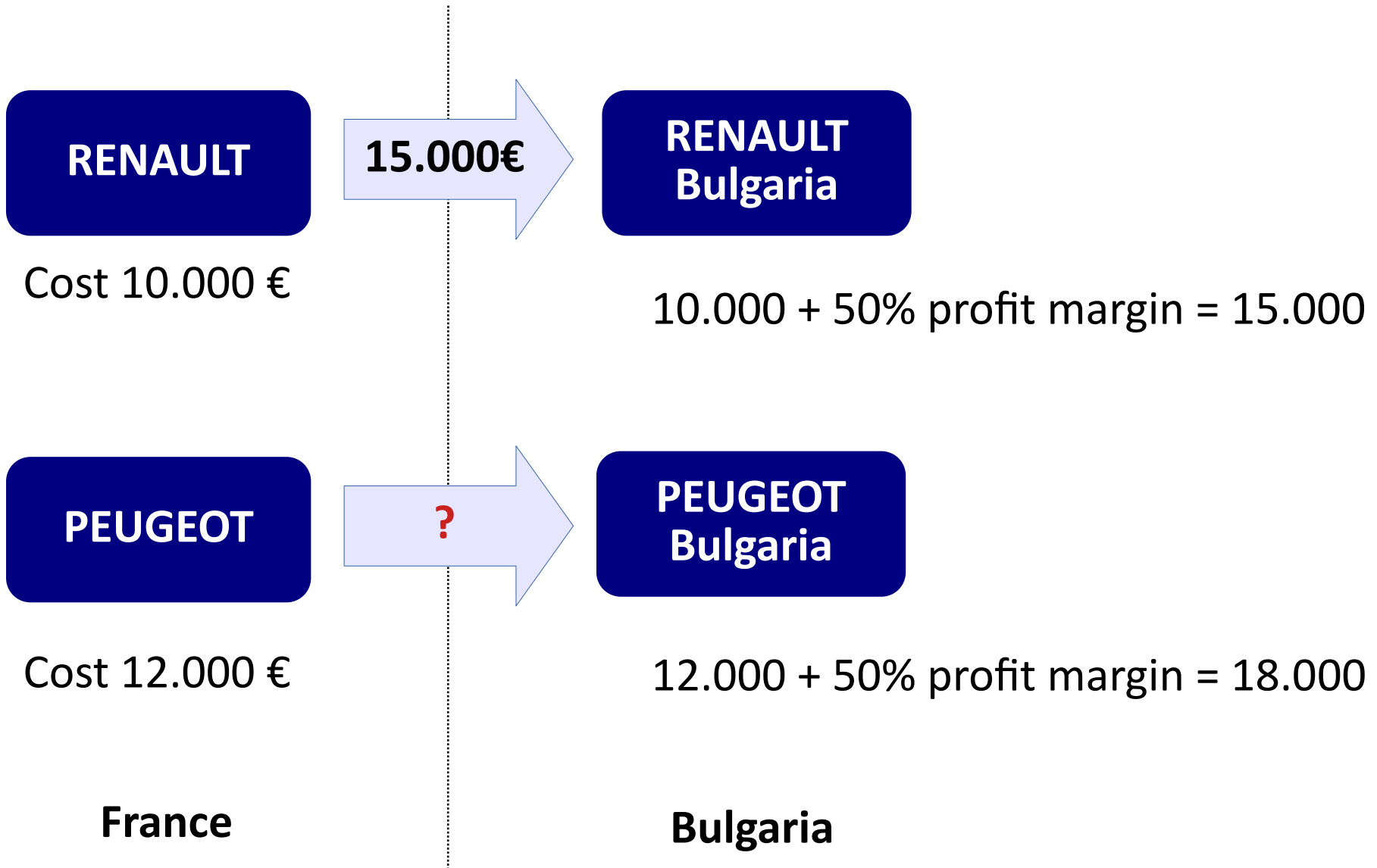
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Resale Price Method



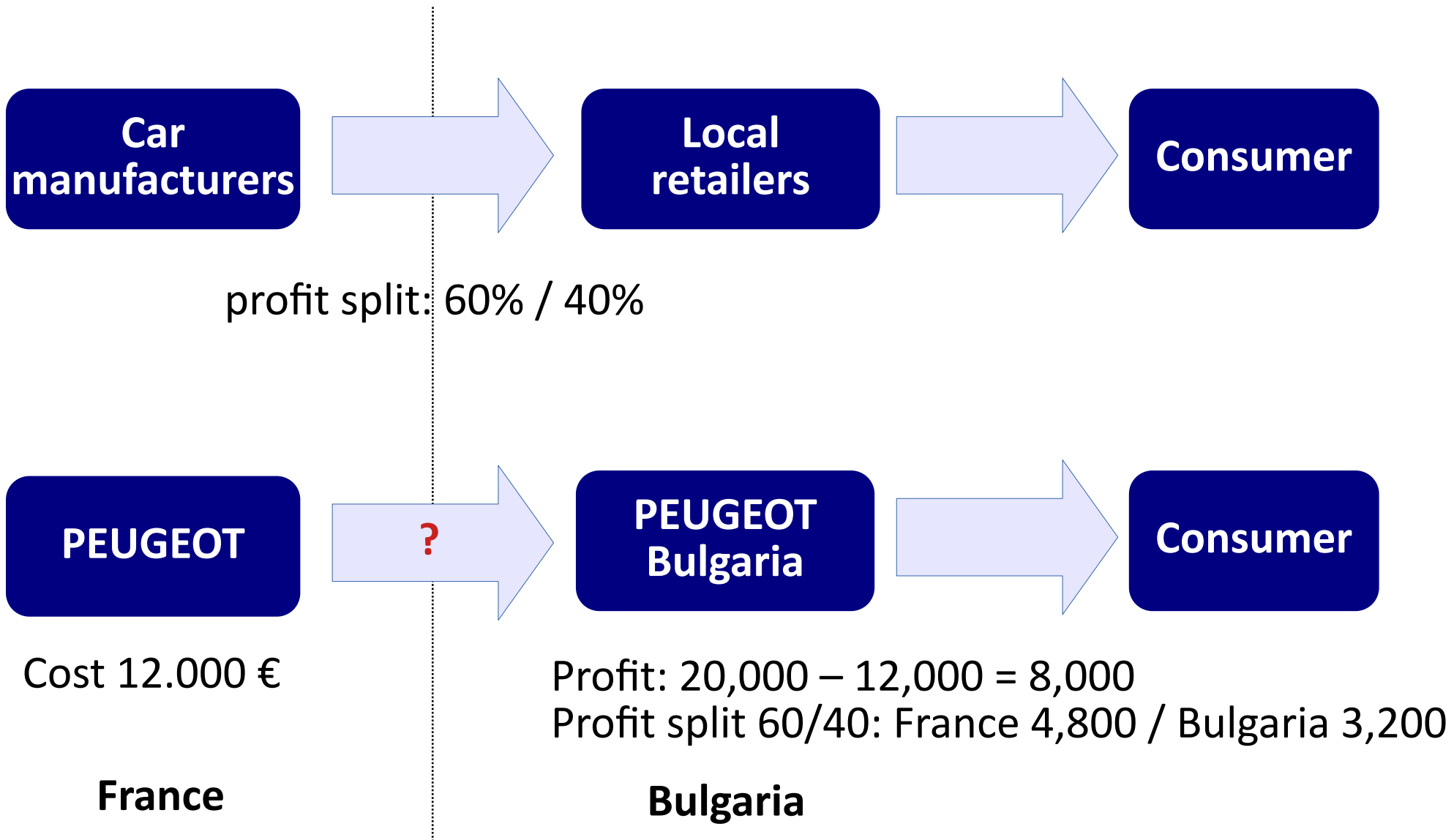
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Cost Plus Method



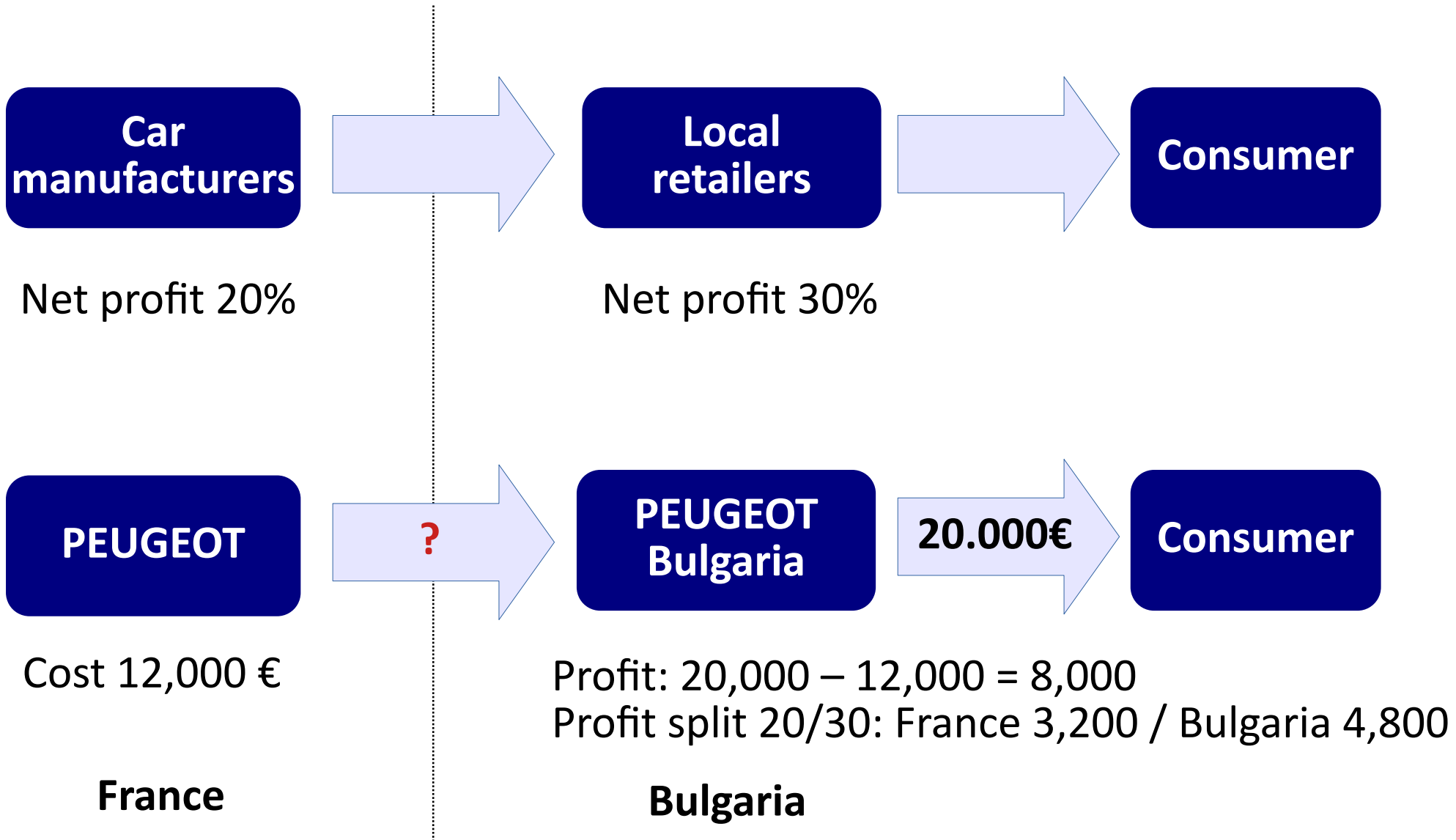
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Profit Split Method



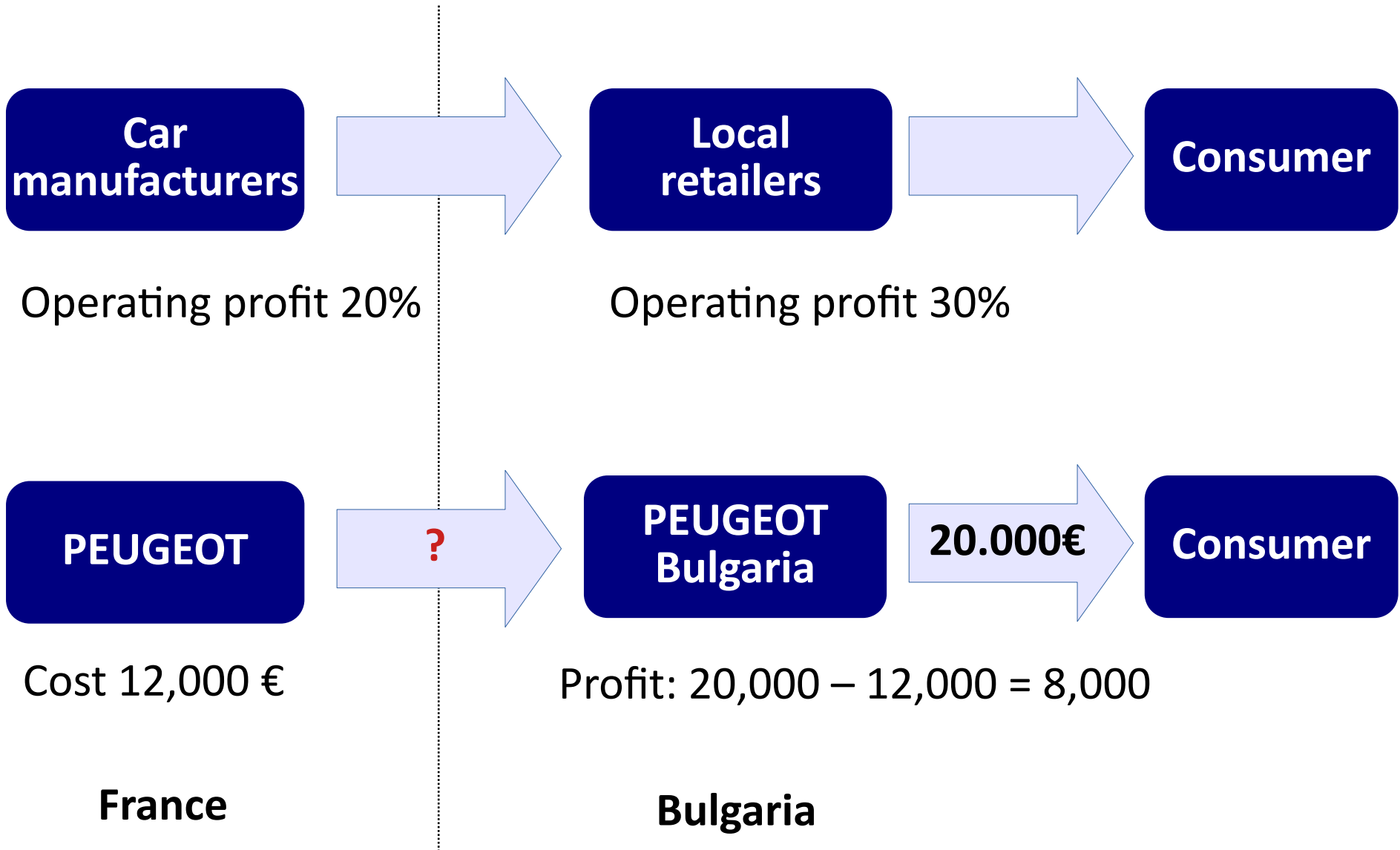
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Transactional Net Margin Method



Transfer pricing

Comparable Profits Method



Transfer pricing

Comparable Profits Method



Operating profit 20%

Operating profit 30%

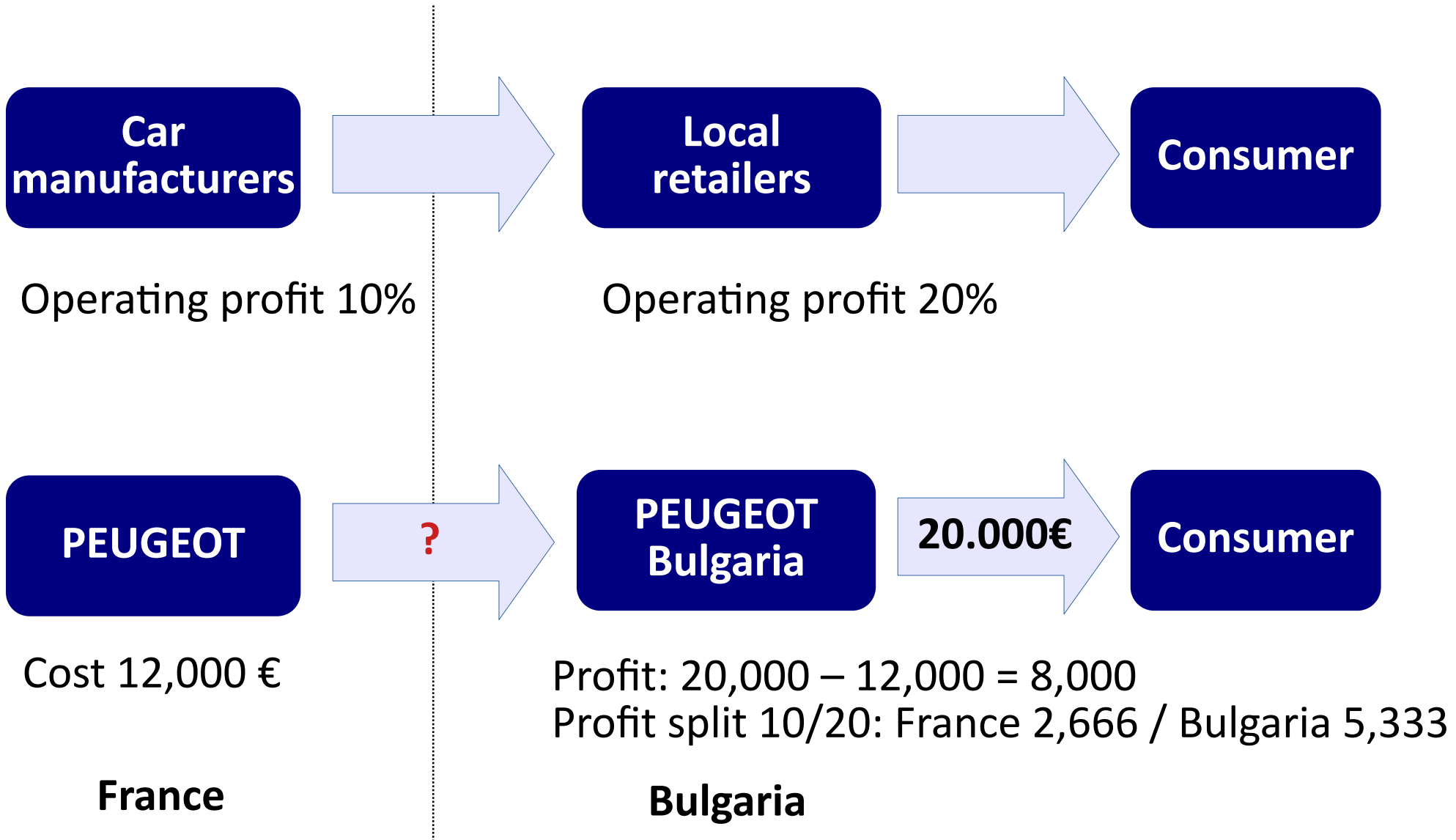
Operating profit: the profit a company has left over after meeting its operating costs (gross profit) but before paying its taxes

France

Bulgaria

Transfer pricing

Comparable Profits Method

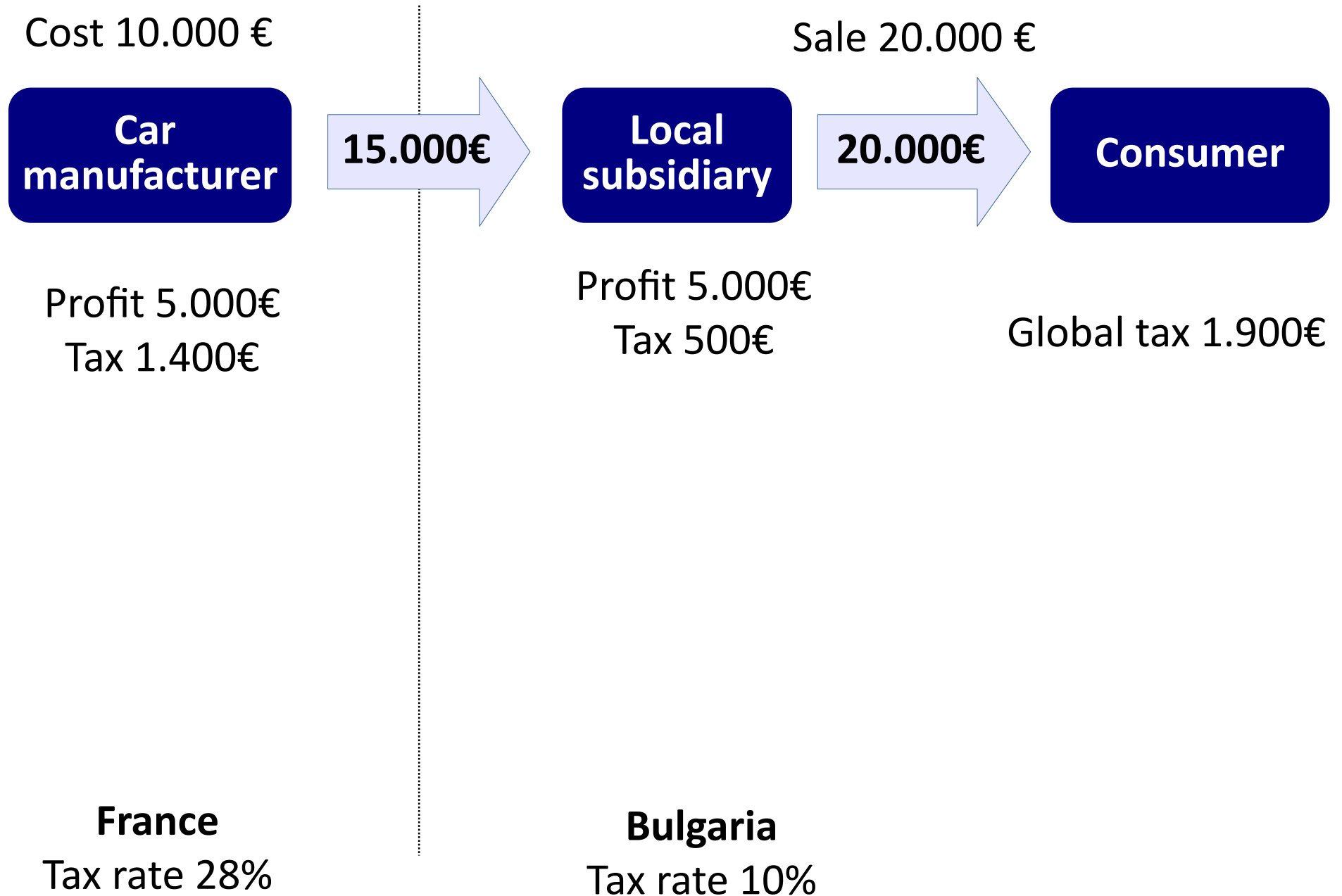


Transfer pricing

Arm's Length Principle

- If a transfer price does not comply with the arm's length principle
 - ◆ Tax authorities may adjust profits (primary adjustment)
 - ◆ If a profit adjustment is not consistent between two states, double taxation ensues
 - ◆ Elimination of double taxation through a secondary adjustment by the other state (Art. 9 OECD Model)
 - ◆ If the other state objects, the primary adjustment may as well be readjusted (secondary adjustment)

Transfer pricing



Transfer pricing

Cost 10.000 €

Sale 20.000 €

Car manufacturer

15.000€

Local subsidiary

20.000€

Consumer

Profit 5.000€
Tax 1.400€

Profit 5.000€
Tax 500€

Global tax 1.900€

Car manufacturer

15.000€

Local subsidiary

20.000€

Consumer

Profit 8.000€
Tax 2.240€

Profit 5.000€
Tax 500€

Global tax 2.740€

Bulgaria

18.000€

France

adjustment

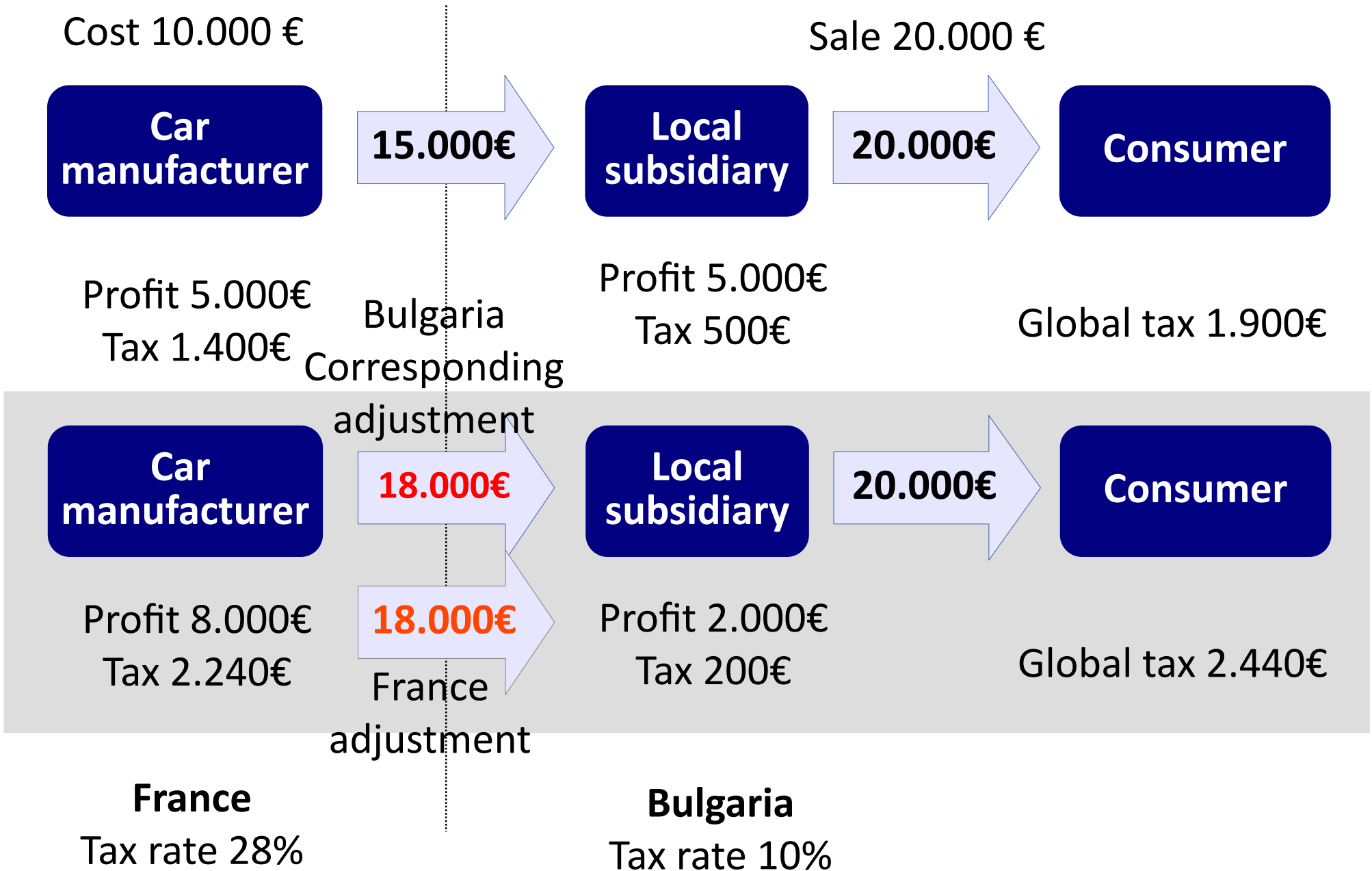
France

Tax rate 28%

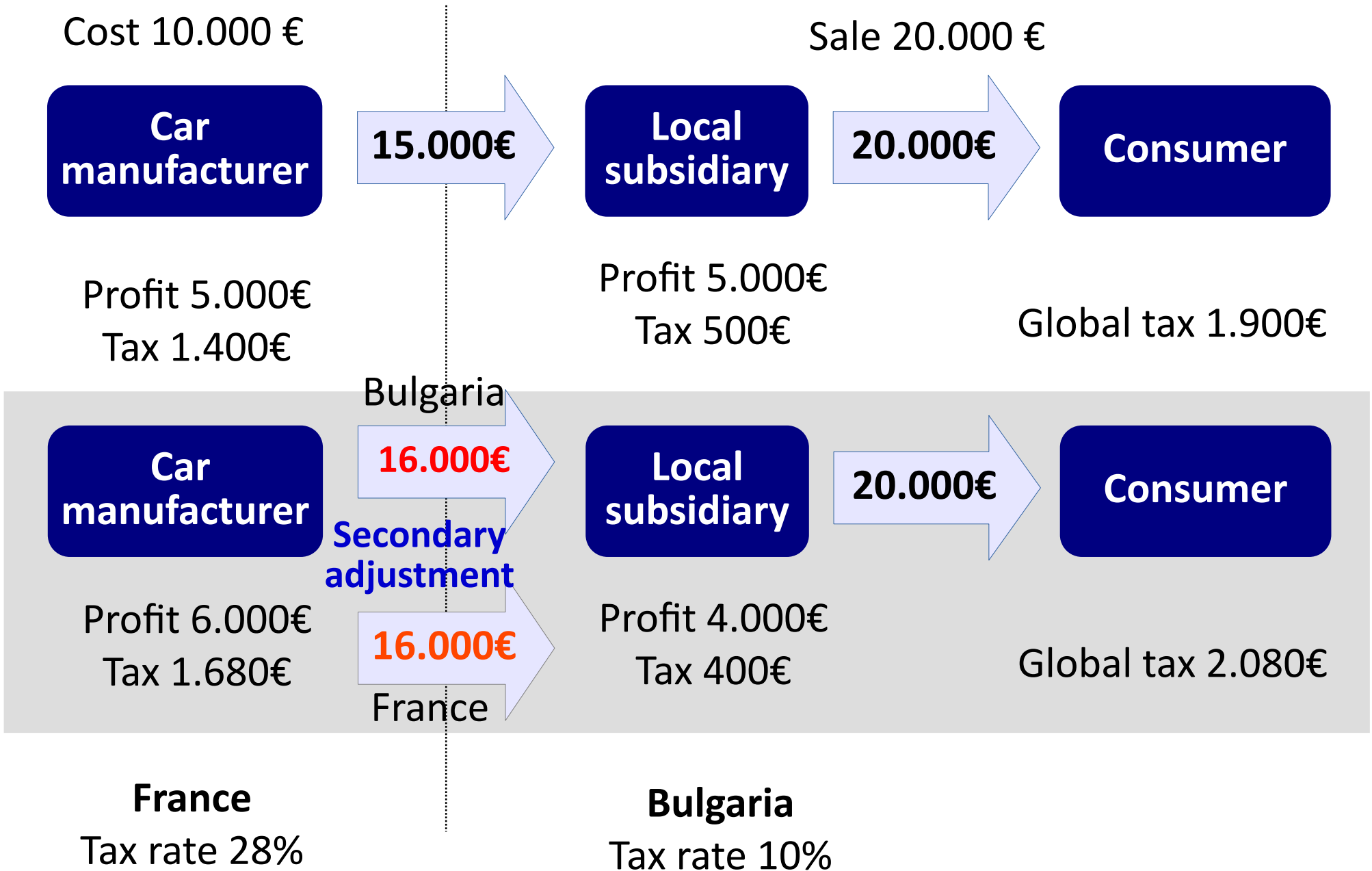
Bulgaria

Tax rate 10%

Transfer pricing



Transfer pricing



Transfer pricing

Arm's Length Principle

- Art. 9 (2) OECD Model:
«2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.»

Transfer pricing

Concept

- Conflicts resolved by
 - ◆ National litigation
 - ◆ Mutual agreement procedure
 - ◆ National/international Arbitration

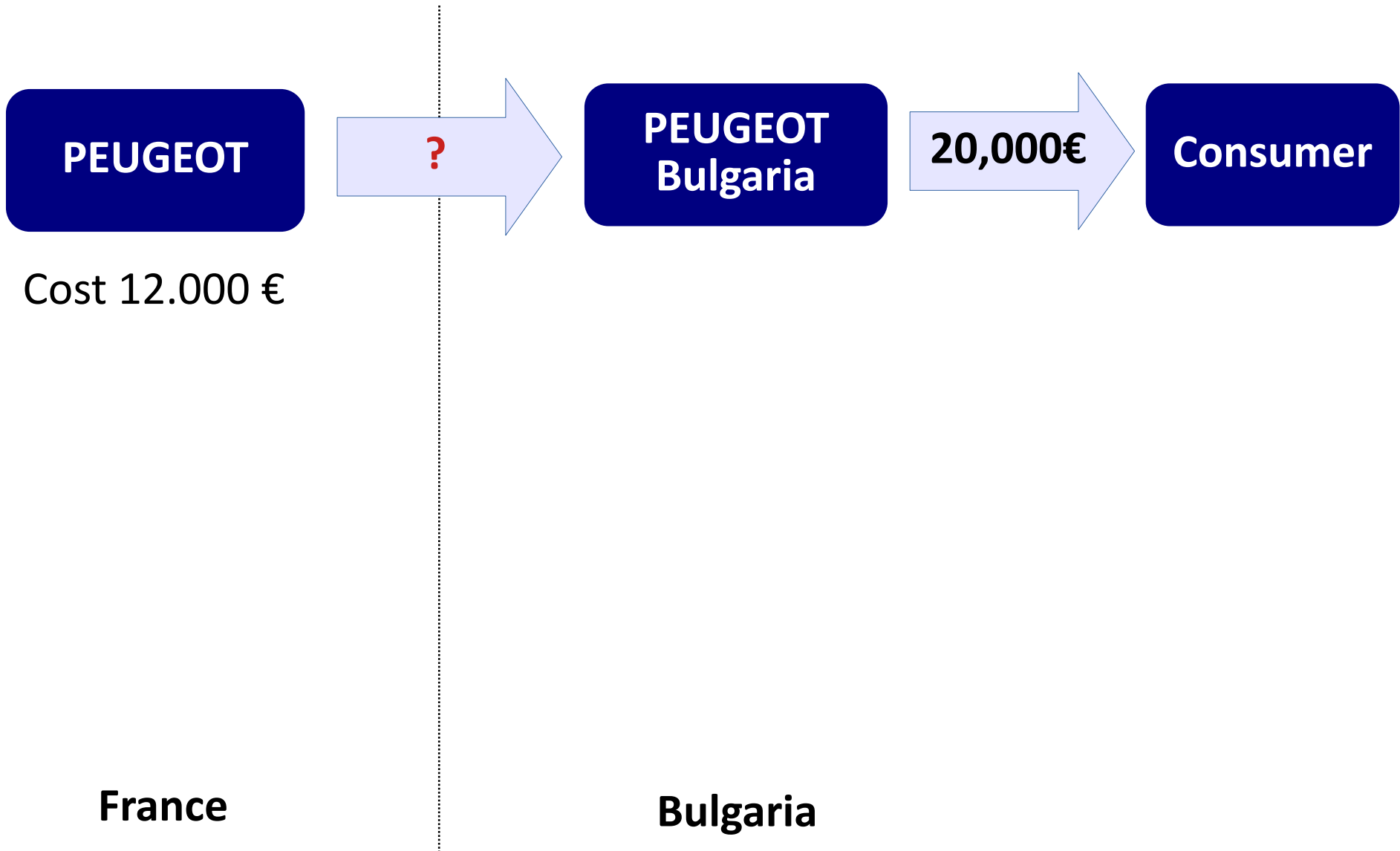
Transfer pricing

Unitary taxation

- Unitary taxation
 - ◆ Profits of a particular business are computed without reference to the legal form in which the business is organized, i.e. as if the profits earned by different members of a corporate group were earned by a single company
 - ◆ Then profits are allocated to the states affected according to predetermined factors,
 - e.g. property, payroll and revenue (so-called “Massachusetts Formula”)
- Various forms of unitary taxation
 - ◆ Formulary apportionment method
 - ◆ Tax consolidation
 - ◆ Common tax base (e.g. proposal for an EU Common Consolidated Corporate Tax Base - CCCTB)
 - ◆ Consolidated reporting
- OECD does not favour unitary taxation because the results do not conform with the arm’s length principle

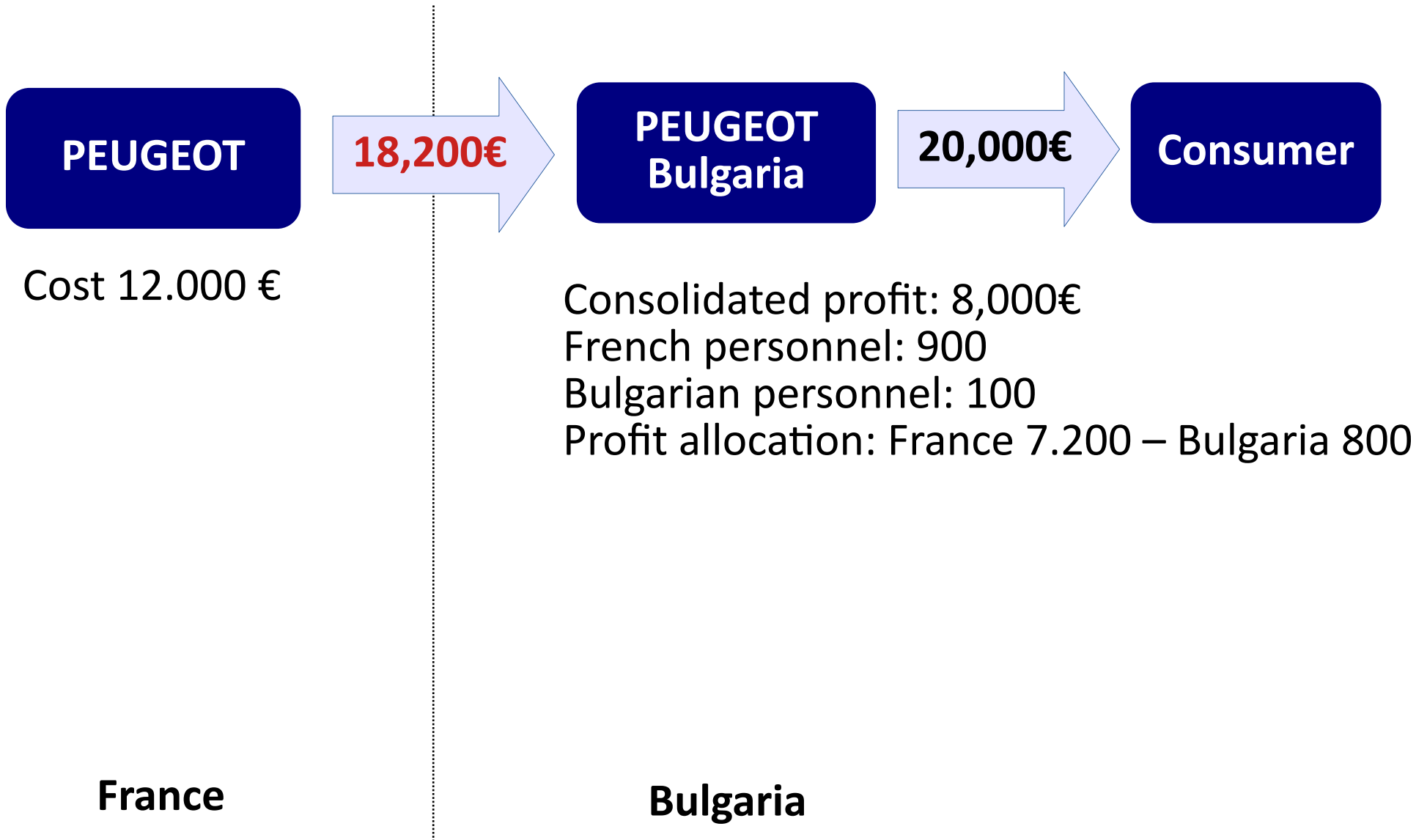
Transfer pricing

Unitary taxation



Transfer pricing

Unitary taxation



Transfer pricing

Legal framework

- Domestic legislation
- International legislation
 - ◆ Bilateral treaties
 - Treaties for the Elimination of Double Taxation
 - Treaties on the International Exchange of Information
 - ◆ Multilateral treaties
 - EU Arbitration Convention (1990)
 - Multilateral Instrument (2017)
- Soft law (often adopted into domestic legislation)
 - ◆ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations
 - First published in 1997
 - Last updated in 2017
 - ◆ EU Code of Conduct on Transfer Pricing Documentation (2006)

Transfer pricing

Transfer pricing administration

- Problems
 - ◆ Difficulty in determining transfer prices
 - ◆ Comparison data is not always available
- Measures
 - ◆ Increased declaration obligations
 - ◆ Documentation
 - ◆ Special audits
 - ◆ Advance Pricing Agreements (APAs)

Transfer pricing

Transfer pricing administration

- Transfer pricing documentation
 - ◆ Set of documents elaborating transfer prices of an enterprise
 - ◆ Prepared by the enterprise
- Legal consequence: burden of proof lies with the taxpayer
- Each country may determine its own rules regarding TP documentation
 - ◆ Nowadays most countries require TP documentation
 - ◆ Rules differ across countries
 - ◆ MNEs must comply with many regimes
 - ◆ Solution: standardised documentation
 - Pacific Association of Tax Administrators (PATA)
 - EU Transfer Pricing Documentation
 - 2013 OECD White Paper: recommendation for the EU approach

Transfer pricing

Transfer pricing administration

- PATA Transfer Pricing Documentation Package: standardised content
 - ◆ Principles
 - Efforts to comply with the arm's length principle in establishing transfer prices
 - Contemporaneous documentation of efforts to comply with the arm's length principle
 - Timely production of documentation evidencing efforts to comply with the arm's length principle
 - ◆ Items to be included
 - Organizational structure
 - Nature of the business/industry and market conditions
 - Controlled transactions
 - Assumptions, strategies, policies
 - Cost contribution arrangements (CCA)
 - Comparability, functional and risk analysis
 - Selection of the transfer pricing method
 - Application of the transfer pricing method

Transfer pricing

Transfer pricing administration

- EU transfer pricing documentation approach (EU TPD)
 - ◆ Objective: harmonisation of TP documentation
 - ◆ EU Code of Conduct on Transfer Pricing Documentation (2006)
 - Council Resolution (2006/C 176/01)
 - Soft law
 - ◆ Characteristics of EU TP Documentation
 - Standardised
 - Partially centralised
 - ◆ Structure
 - Masterfile
 - one uniform set of common standardised information, relevant for all the EU members of the group
 - Country-specific files
 - several sets of standardized documentation each containing country-specific information

Transfer pricing

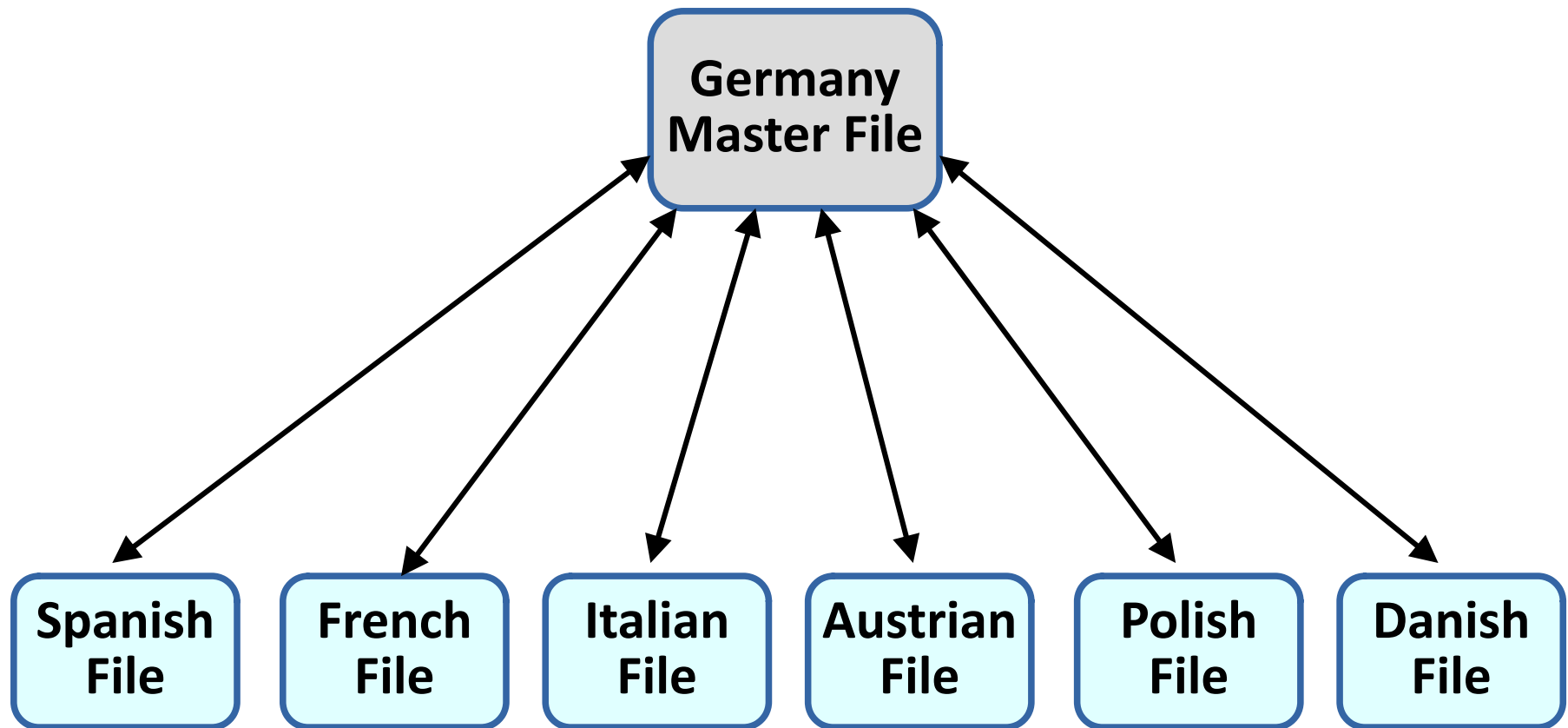
Transfer pricing administration

- Example: German multinational with subsidiaries in all EU countries

Transfer pricing

Transfer pricing administration

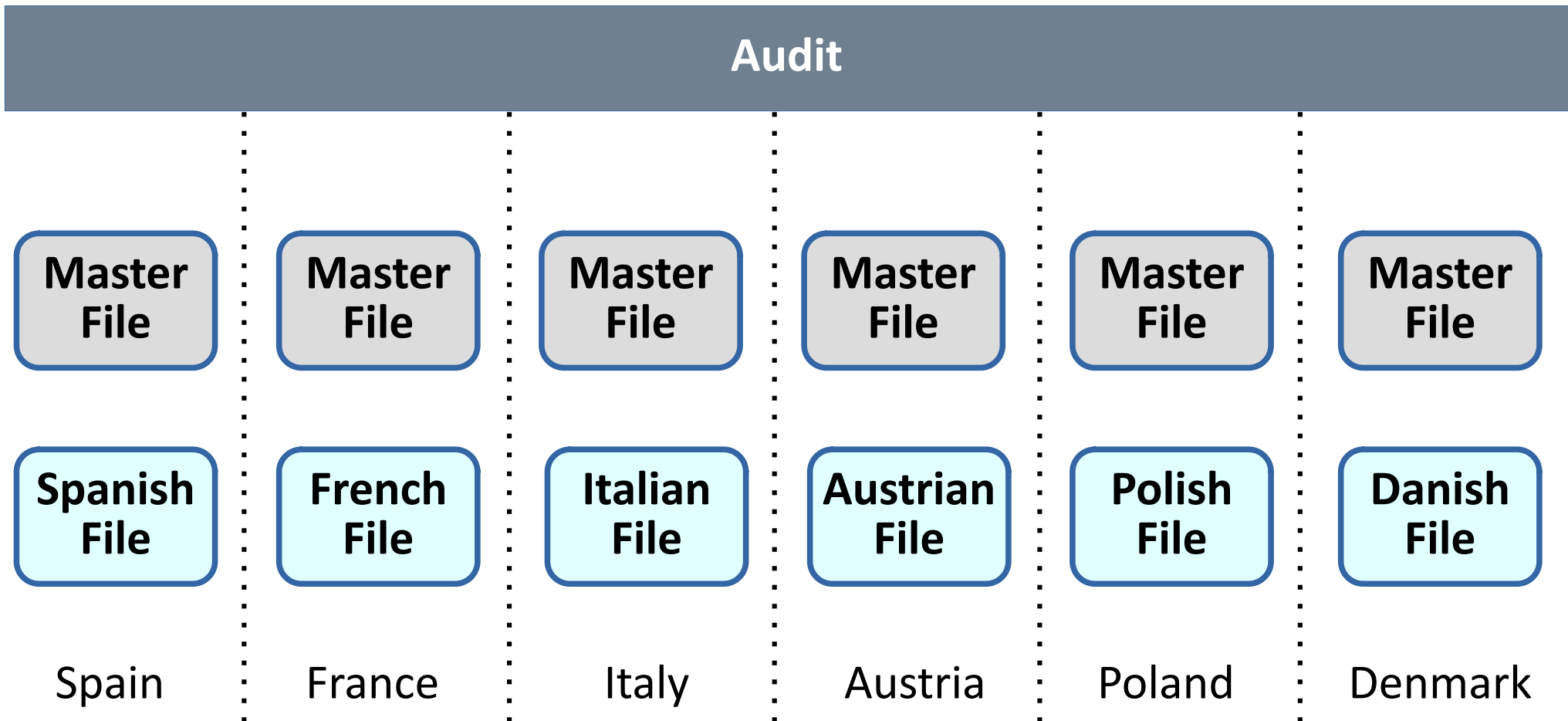
- Example: German multinational with subsidiaries in all EU countries



Transfer pricing

Transfer pricing administration

- Example: German multinational with subsidiaries in all EU countries



Transfer pricing

Transfer pricing administration

- Drafting the documentation
 - ◆ Usually the documentation files are drafted once
 - ◆ Updated each year
 - ◆ Deadline: usually the date of filing the annual tax return
- Requirements
 - ◆ Methodology must remain constant
 - ◆ Documentation must be contemporary
- Submitting the documentation
 - ◆ Automatically
 - ◆ Upon request (audit)

Transfer pricing

Transfer pricing administration

- BEPS Action 13: Developing rules for transfer pricing documentation
 - ◆ Action 13 Report (2015): 3-tier approach
 - Master file
 - Local file
 - Country by Country (CbC) report
 - Table 1 – overview of allocation of income, taxes and business activities by tax jurisdiction
 - Table 2 – list of constituent elements of the MNE group in each jurisdiction
 - Table 3 – additional information

Transfer pricing

Transfer pricing administration

- CbC reporting
 - ◆ CbC reports to be filed in the residence state of the parent company
 - ◆ CbC reports are included in the automatic exchange of information
- Implementation
 - ◆ Unilaterally
 - ◆ Bilaterally
 - ◆ Included in the MLI (Multilateral Instrument)
 - ◆ EU Directive 2016/881/EU (Directive on Administrative Cooperation, "DAC 2")

Transfer pricing

Transfer pricing administration

- Advance Pricing Arrangements (OECD,UK) / Agreements (US) - APAs
 - ◆ An agreement between a taxpayer and a tax administration as to the transfer pricing methods that will be used to determine the arm's length price in transactions between the taxpayer and related parties.
- APAs
 - ◆ do not set out transfer prices
 - ◆ set out the critical assumptions for determining transfer prices
- APA categories
 - ◆ Unilateral: taxpayer and one tax administration
 - ◆ Bilateral: taxpayer and two tax administrations
 - ◆ Multilateral: taxpayer and more than two tax administrations
- Benefits
 - ◆ Legal certainty
 - ◆ Facilitation of audits
 - ◆ Prevention of tax disputes

Tax planning

Case study

A Dutch company takes a loan of EUR 1,000,00 from a German company which belongs to the same multinational group. The intention of the Lender and the Borrower is that the loan is interest-free

The contracting parties request your professional opinion as to whether there are any tax obstacles