Lecture 10

2023/11/28

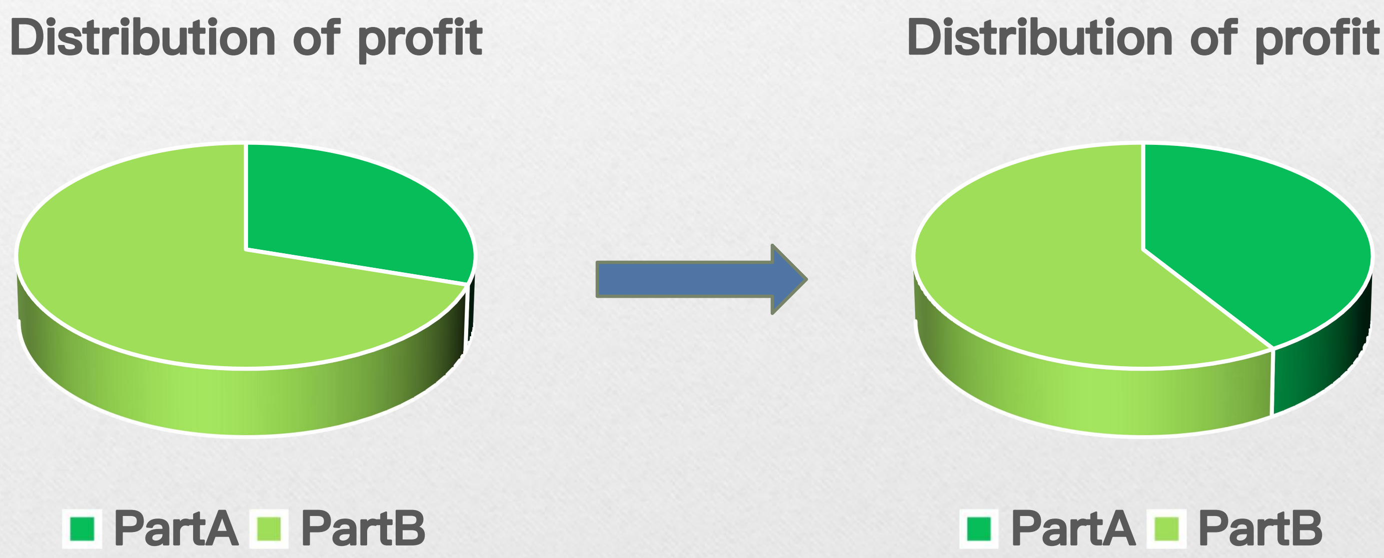
International Taxation

Chapter 4 International Transfer Pricing

Transfer Pricing ?

Transfer pricing is the setting of the price for goods and services sold between controlled (or related) legal entities.

Transfer prices affect the distribution but not the absolute amount of gain or loss among related persons



Transfer prices

- help an MNC identify those parts of the enterprise that are performing well and not so well.

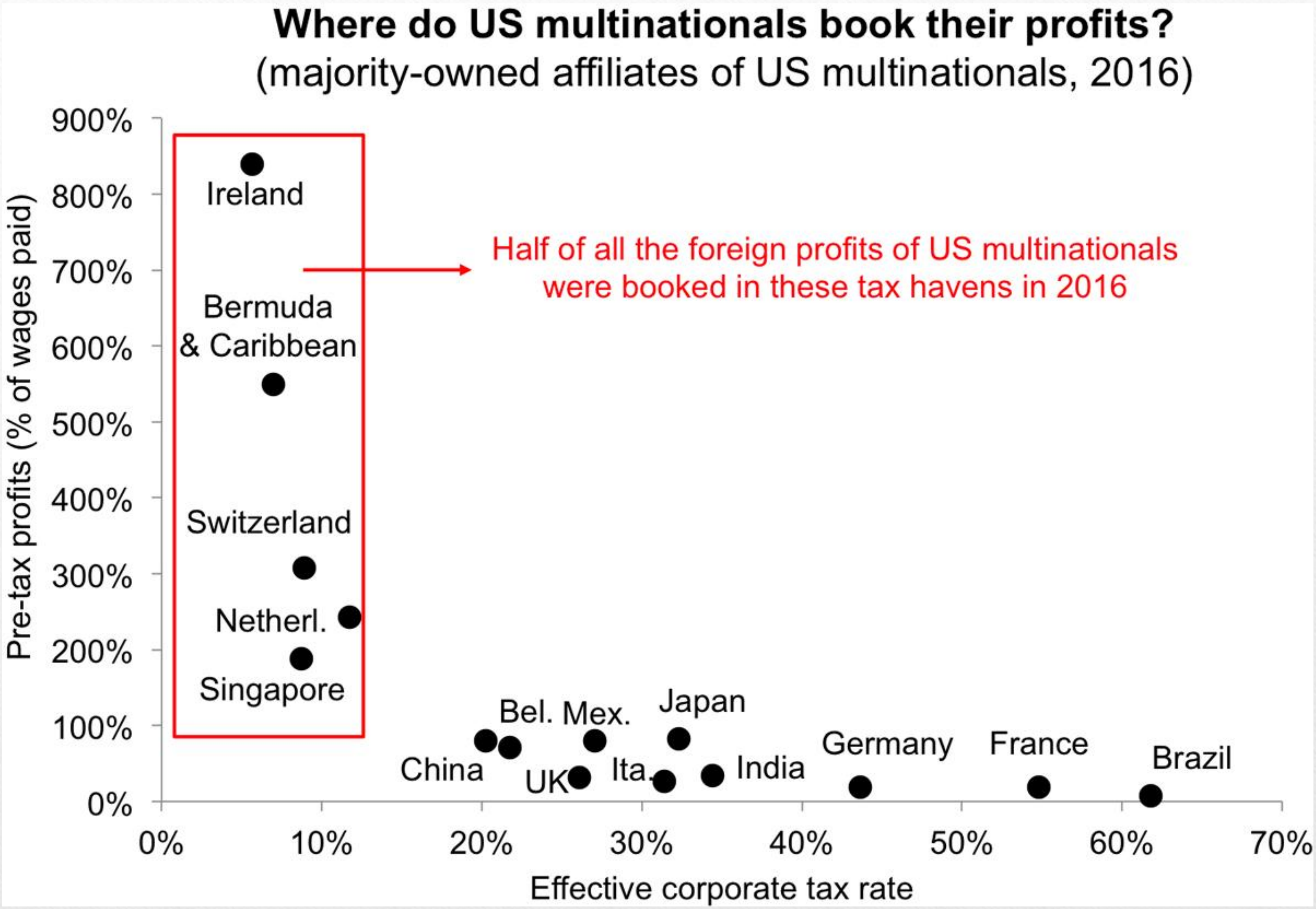
Inappropriate transfer pricing

- deprive governments of their fair share of taxes from global corporations
- expose multinationals to possible double taxation

Transfer Pricing

Drawing by David Rooney

No country – poor, emerging or wealthy – wants its tax base to suffer because of transfer pricing.


Where do US multinationals book their profits?
(majority-owned affiliates of US multinationals, 2016)
Pre-tax profits (% of wages paid)
900%
800%
700%
600%
500%
400%
300%
200%
100%
0%
Ireland
Bermuda
& Caribbean
Switzerland
Netherl.
Singapore
Half of all the foreign profits of US multinationals
were booked in these tax havens in 2016
Bel. Mex.
Japan
China
UK
Ita.
India
Germany
France
Brazil
0%
10%
20%
30%
40%
50%
60%
70%
Effective corporate tax rate

Transfer Pricing: Example

A French bicycle manufacturer distributes its bikes through a subsidiary in the Netherlands. The bicycle costs €900 to make and it costs the Dutch company €100 to distribute it. The Dutch unit retails the bike at €2000 in the Netherlands. Overall, the company has thus made €1000 in profit, on which it expects to pay tax. Assume the tax rates of France and Netherlands are 40% and 10%. The transfer price now is €1700, what if the parent change the price to €1100?

Transfer Pricing : Example

	Parent (France)	Subsidiary (Netherlands)
Before Transfer Pricing Change		
Cost		
Income		
EBIT		
Tax rate		
After Transfer Pricing Change		
Cost		
Income		
EBIT		
Tax rate		

Transfer Pricing : Example

	Parent (France)	Subsidiary (Netherlands)
Before Transfer Pricing Change		
Cost	900	1700+100
Income	1700	2000
EBIT	800	200
Tax rate	40%	10%
After Transfer Pricing Change		
Cost	900	1100+100
Income	1100	2000
EBIT	200	800
Tax rate	40%	10%

Transfer Pricing : Example

	Parent (France)	Subsidiary (Netherlands)	consolidated
Total profit reported on tax return	800	200	1000
Tax rate	40%	10%	
Tax liability before change to transfer price	320	20	340
Global ETR			34%
ETR Effect of Transfer Pricing Change			
Totoal profit after the change of transfer pricing	200	800	1000
Tax rate	40%	10%	
Tax liability after transfer pricing change	80	80	160
Global ETR			16%

Arm’s Length Price

Prices charged after bargaining between unrelated persons are called “arm’s length” prices.

A price charged between related persons that approximates the result of independent bargaining is also called an “arm’s length” price.

Arm's Length Price

Corporations... Want to reduce overall tax burden by manipulation of **inter-company prices**

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Tax authorities... Want to ensure that the inter-company price is equivalent to **ALP** to prevent the loss of tax revenue

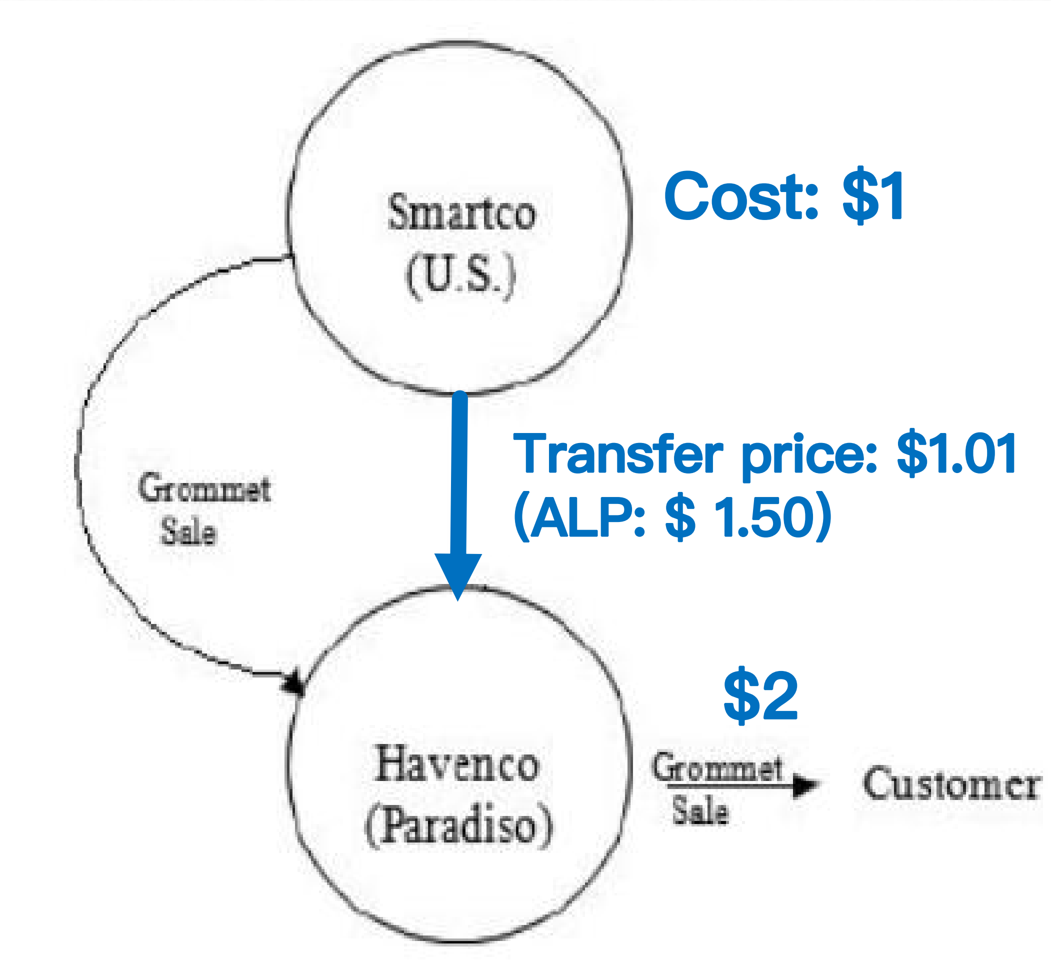
Arm's Length Price

1	**Price of intermediate goods** produced by one company within the multinational group and sold to another
2	**License or royalty fee** paid for the right to produce and to use intellectual property owned by another part of the group
3	**Interest** paid for the inter-company loans that are made from one business unit of a corporation to another
4	**Rental fee** paid for the right to use the tangible property owned by another part of the group
5	**Service compensation** paid by one company within the multinational group for the services between related parties

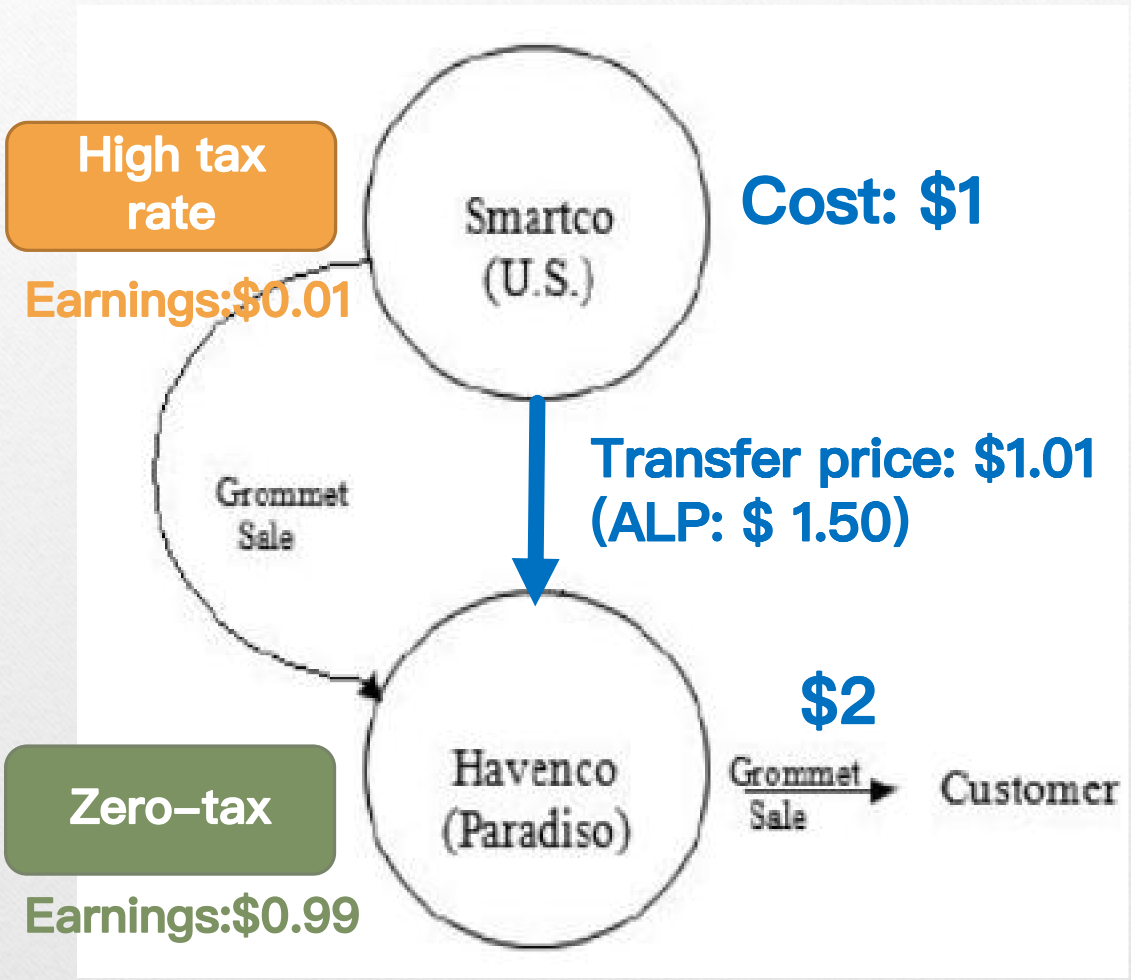
Arm’s Length Price: Example

- Smarco is a U.S. corporation subject to high-income tax. Smartco produces grommets at a cost of $1 each and can sell them in Paradiso (a zero-tax country) for $2. Instead of selling to the customer directly, Smartco sells the grommets to its paradisan subsidiary Havenco for $1.01. Havenco in turn sells to unrelated Paradisan customers for $2.

Arm's Length Price: Example



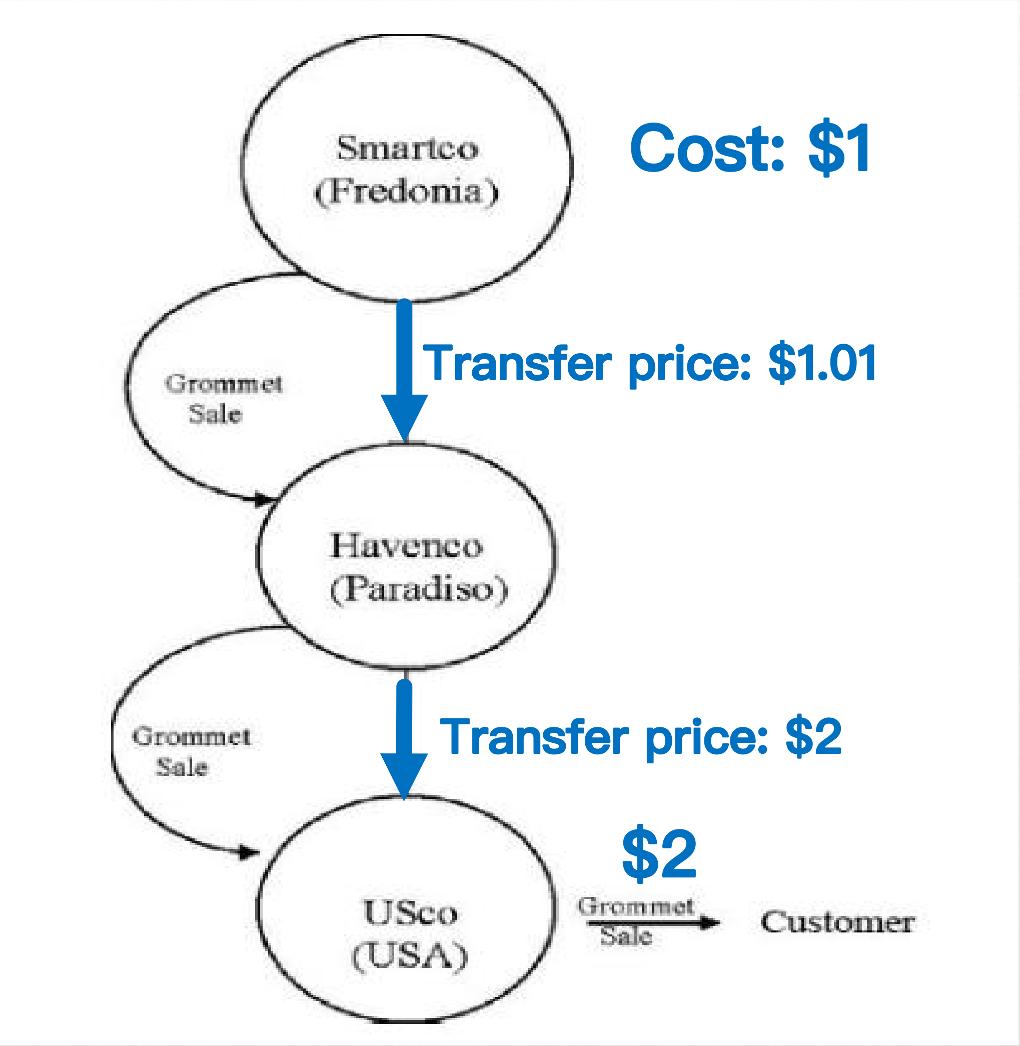
Arm's Length Price: Example



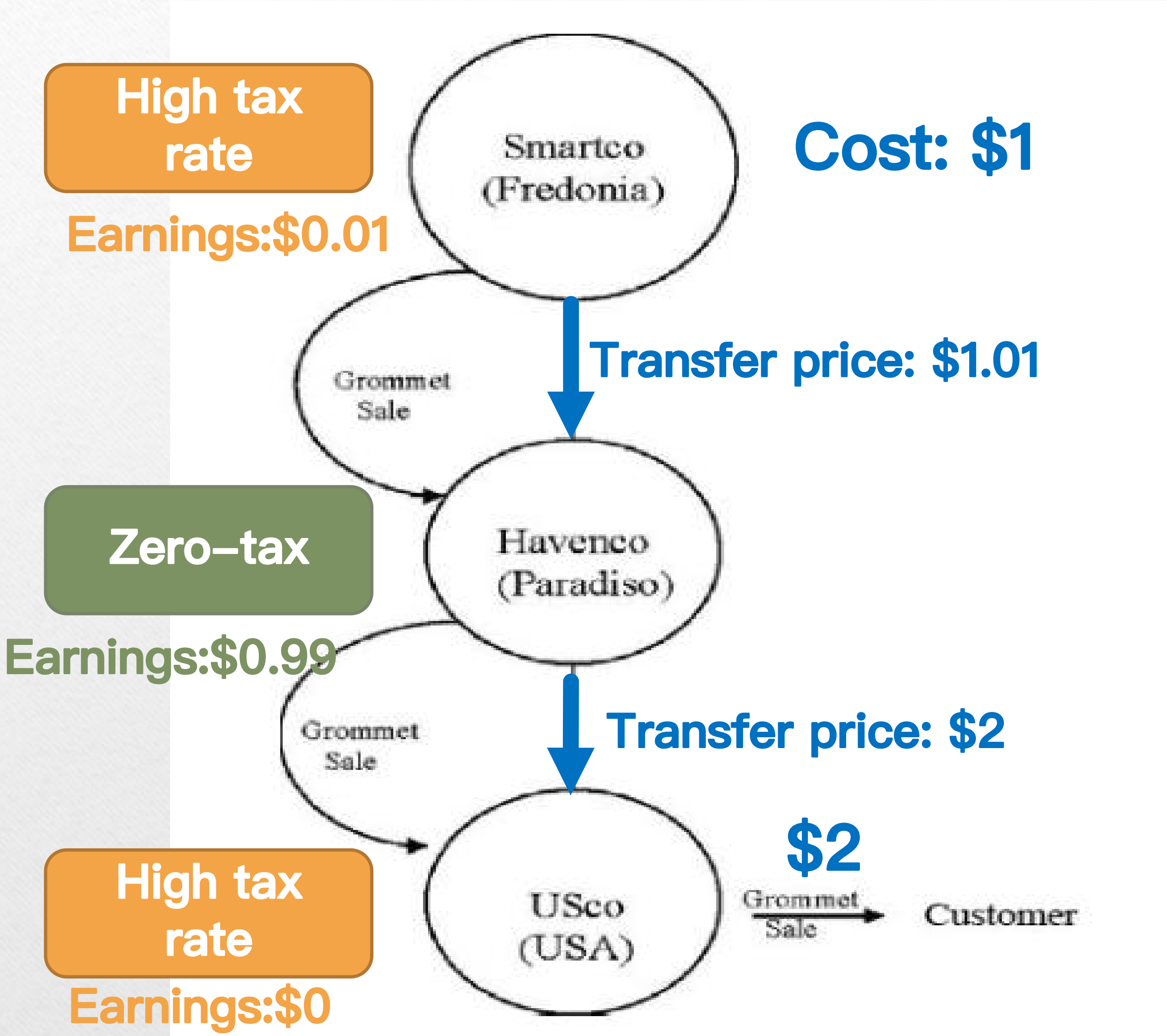
Arm’s Length Price: Example

- Now Smartco is a Fredonian corporation that makes grommets. Suppose Fredonia is a high-tax country. If Smartco itself sold grommets in the United States, its entire gain would attract U.S. or Fredonian tax, or both. As before Smartco sells the grommets to its Paradisan subsidiary Havenco for $1.01. Havenco resells the grommets to its own U.S. distribution subsidiary, US co, for $2. What’s the tax consequence for each subsidiary?

Arm's Length Price: Example



Arm's Length Price: Example



Section § 482

The core provision in Section § 482 empowers the IRS to reallocate income and expense in transactions among related persons so as to reflect income clearly:

"In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

Section § 482

If transactions between related persons on terms that differ substantially from similar transactions at arm's length between unrelated persons

Subject to immediate and unanswerable revision by the IRS.

If related parties can point to identical, or even substantially similar, arm's length transactions between unrelated persons,

Nearly immune from molestation

The Elusiveness of ALP

- **The problem with the arm's length standard**

Step1: Find transfers of generic "brand X" → Sometimes impossible

Step2: Strip away the differentiated features → Leaves much room open for argument

Related Persons

Despite the difficulty, the Regulations under §482 embrace arm's length pricing as the test of clear reflection of income.

The Regulations press hard to come up with arm's length touchstones for intra-family transactions.

A "related" or "controlled" taxpayer means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers.

"It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted."

Rule of Thumb: **common beneficial ownership or voting control of 50 percent or more may set the stage for an allocation under §482.**

Transfer Pricing Methodologies

Find comparable transactions

(1) Transaction-based methodology

(2) Profit-based methodology

Benchmark the profits

Transfer Pricing Methodologies

Tangible Property	Intangible Property	Services
Transactional methods		
Comparable Uncontrolled Price Method	Comparable Uncontrolled Transaction Method	Comparable Uncontrolled Services Price Method
Resale Price Method		Gross Services Margin Method
Cost Plus Method		Cost of Services Plus Method
Profit methods		
Profit Split Methods	Profit Split Methods	Profit Split Methods
Comparable Profits Method	Comparable Profits Method	
		Services Cost Method

Comparable Uncontrolled Price Method

the **price** charged for property or services transferred in a **controlled transaction**

↕

the **price** charged for property or services transferred in a **comparable uncontrolled transaction in comparable circumstances.**

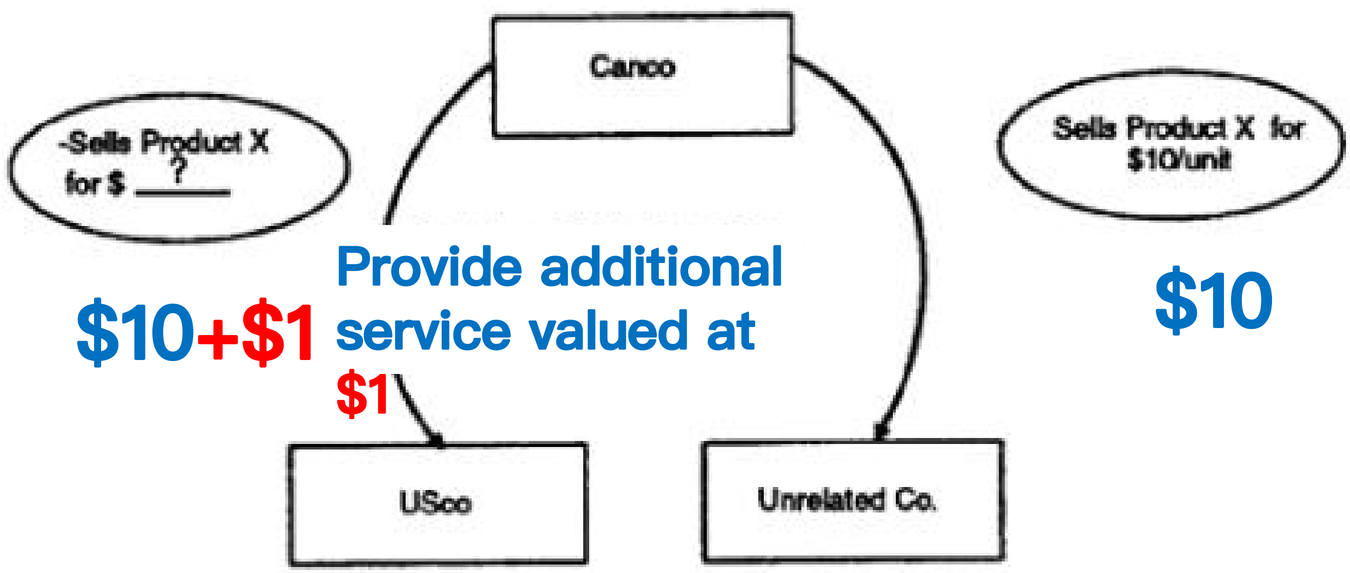
product quality
sales volume
contractual terms
geographic market
embedded intangibles
foreign currency risks

Example

- A parent company Canco located in Canada manufactures "product X." Canco sells product X to both related （USCO） and unrelated distributors in the United States and the circumstances surrounding the controlled and uncontrolled transactions are substantially the same. Under the CUP method, if Canco sells product X to the unrelated distributors for $10/unit, then Canco should sell product X to USCO at the same price to satisfy the arm's length principle. However, assume that Canco arranges for and pays to ship product X to USCO whereas the unrelated entities pick up product X directly from Canco's manufacturing facility. Assuming the additional compensation Canco should receive for performing the additional activities equals $1/unit, how much should Canco charge USCO?

CUP Method: Example

CUP Example



The price to USco should be $11/unit which equals the price to unrelated Co. plus the cost of providing additional services.

Comparable Uncontrolled Transaction Method

the amounts charged in controlled transfers of **intangible property**

amounts charged in comparable third party transactions

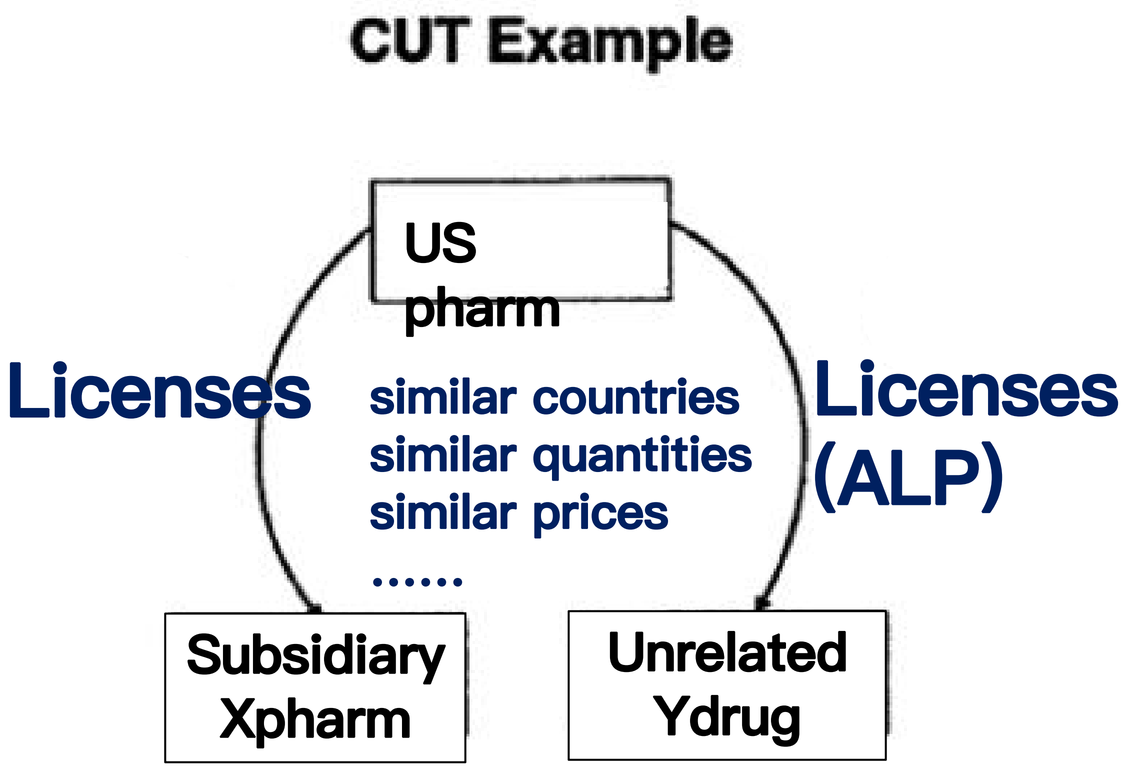
- The terms of transfer
- Stage of development of the intangible
- Duration of agreements
- Uniqueness of the property

……

CUT Method: Example

- USpharm, a U.S. pharmaceutical company, develops a new drug Z that is a safe and effective treatment for the disease zeezee. USpharm has obtained patents covering drug Z in the United States and in various foreign countries. USpharm has also obtained the regulatory authorizations necessary to market drug Z in the United States and in foreign countries.
- USpharm licenses its subsidiary in country X, Xpharm, to produce and sell drug Z in country X. At the same time, it licenses an unrelated company, Ydrug, to produce and sell drug Z in country Y, a neighboring country. Prior to licensing the drug, USpharm had obtained patent protection and regulatory approvals in both countries and both countries provide similar protection for intellectual property rights. Country X and country Y are similar countries in terms of population, per capita income and the incidence of disease zeezee. Consequently, drug Z is expected to sell in similar quantities and at similar prices in both countries. In addition, costs of producing and marketing drug Z in each country are expected to be approximately the same.
- USpharm and Xpharm establish terms for the license of drug Z that are identical in every material respect, including royalty rate, to the terms established between USpharm and Ydrug. In this case the district director determines that the royalty rate established in the Ydrug license agreement is a reliable measure of the arm's length royalty rate for the Xpharm license agreement.

CUT Method: Example(2)



Resale Price Method

Resale Price Method: For distributors that resell products without physically altering or adding substantial value

the ALP at which a distributor would **purchase products** from a related party

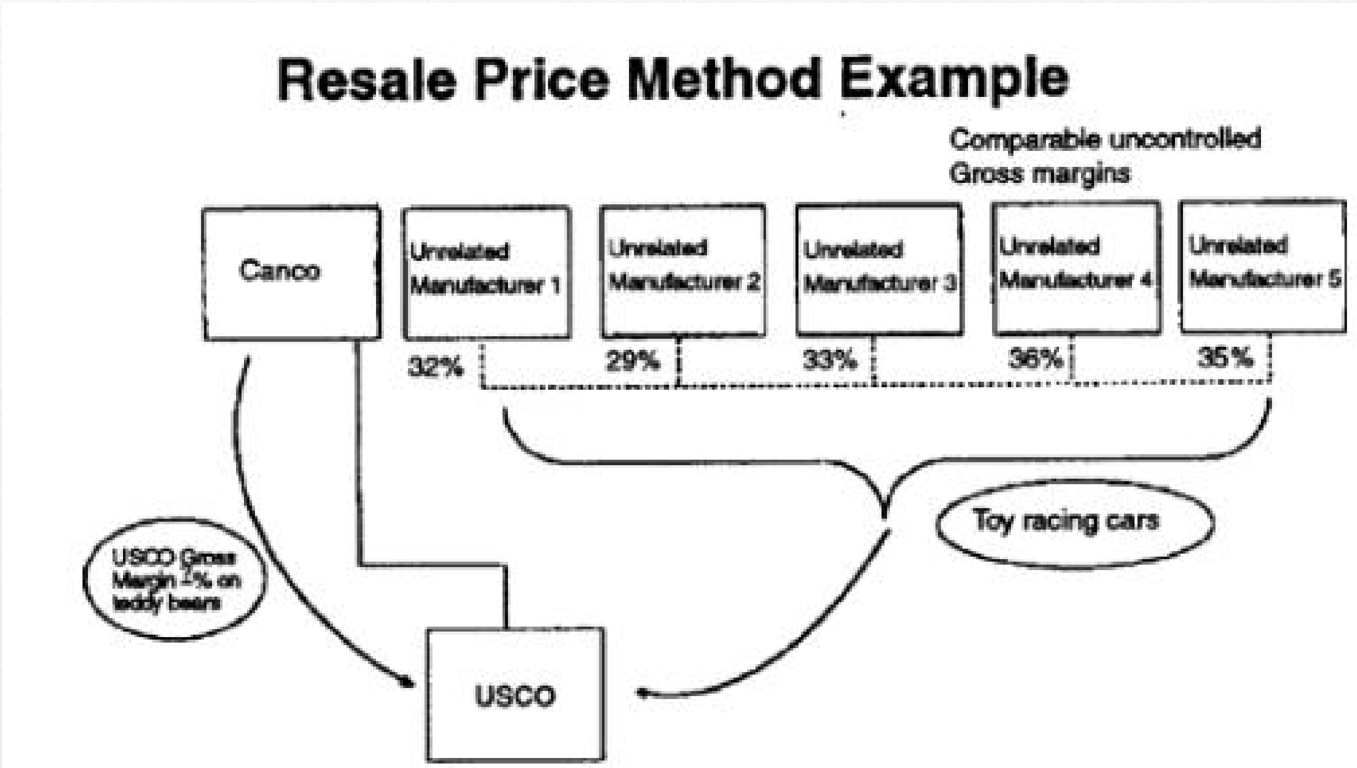
=

the applicable resale price of the property involved in the controlled transaction.

−

the appropriate gross profit

Resale Price Method: Example



Resale Price Method: Example

Gross margins resulting from USCO's purchases of toy racing cars from five manufacturers under comparable terms :

Unrelated Manufacturer 1	29%
Unrelated Manufacturer 2	32%
Unrelated Manufacturer 3	33%
Unrelated Manufacturer 4	35%
Unrelated Manufacturer 5	36%

The Interquartile range (i.e. the middle 50 percent)

USCO's purchases of teddy bears from its related parties should be set at a price that will allow USCO to earn a gross margin of between 32% to 35% on the sale to third party customers.

Resale Price Method: Example

Resale price method (illustration):

Sales price to independent customers	1,000
Resale margin (*i.e.* gross margin) (*e.g.* 40%)	400
Cost of goods sold: transfer price	(600)
Selling and other operating expenses	(300)
Operating profit	100

Tested in the resale price method; determined from uncontrolled comparables

(*i.e.* purchase price from associated enterprise)

Resale Price Method

The RPM is unlikely to lead to accurate results if there are significant differences in……

Level of market for which the products are being sold
Type of products
Embedded intangibles

Cost Plus Method

Cost Plus Method: For goods are sold by a manufacturer that does not contribute valuable unique intangible assets or assume unusual risks in the controlled transaction

the ALP at which a manufacturer would **sell products** to a related party

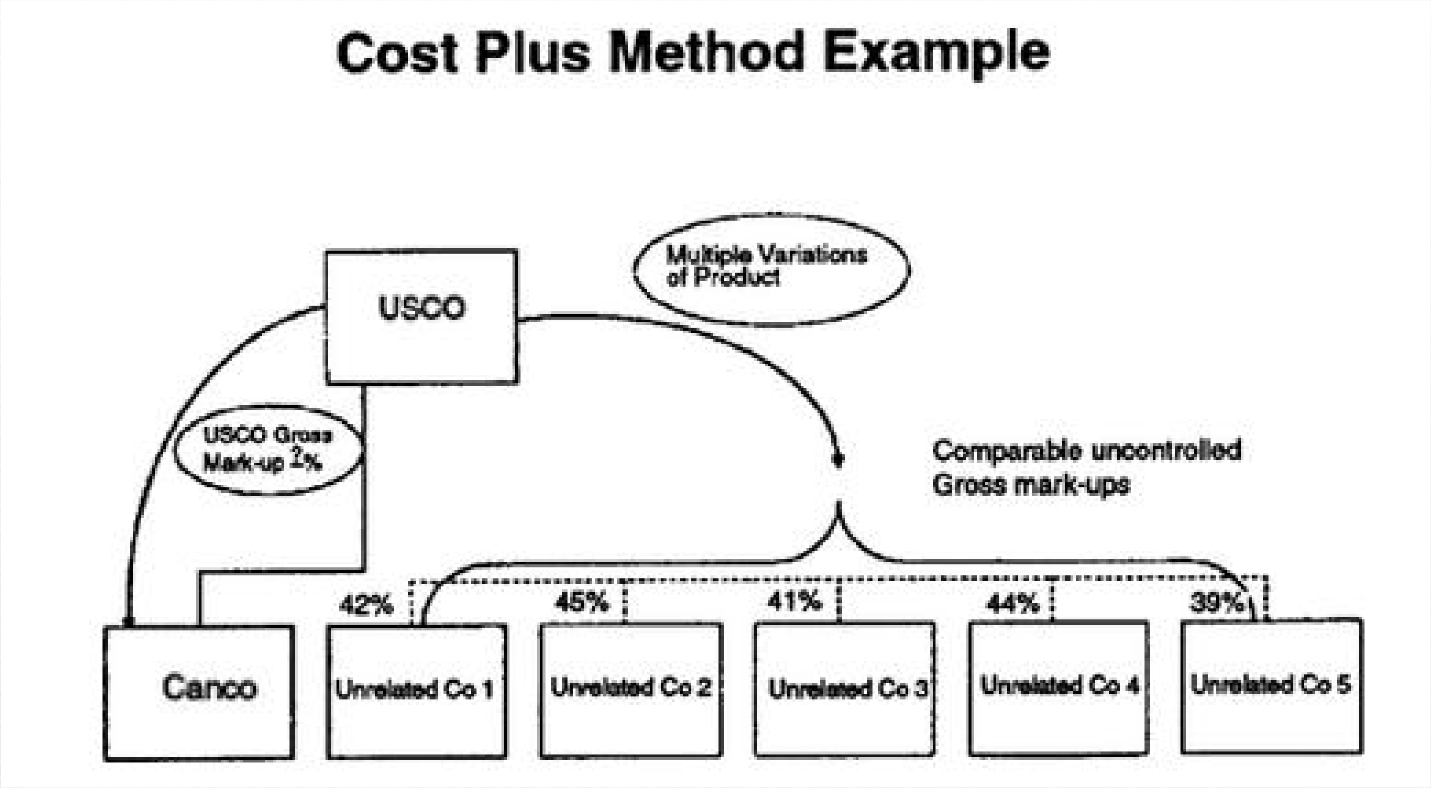
=

controlled taxpayer's cost of producing

+

the appropriate mark up

Cost Plus Method: Example



Cost Plus Method: Example

USCO needs to earn a gross mark-up between 41% and 44% for transactions with Canco to satisfy the arm's length principle.

Unrelated Co1	42%	39%
Unrelated Co2	45%	41%
Unrelated Co3	41%	42%
Unrelated Co4	44%	44%
Unrelated Co5	39%	45%

The Interquartile range (i.e. the middle 50%)

USCO needs to earn a gross mark-up between 41% and 44% for transactions with Canco to satisfy the arm's length principle.

Cost Plus Method

Cost plus method (illustration):

Cost of raw materials	200
Other direct and indirect production costs	100
Total cost base	300
Mark-up on costs (*e.g.* 20%)	60
Transfer price	360
Overheads and other operating expenses	(40)
Operating profit	20

Tested in the cost plus method; determined from uncontrolled comparables

(*i.e.* sale price to associated enterprise)