International Taxation

3rd part: Transfer prices

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Transfer Prices

Significance

- About 50 % of import and export of goods are between group companies
- Therefore huge potential for profit transfers
- In practice, however, limited:
    - Interference with responsibility of profit centres
    - Can lead to wrong management decisions
    - High risk due to tax audits
    - Risk of (economic) double taxation

Transfer Prices

Applicable Law

- National law:
  - Hidden profit distribution
- International:
  - Art. 9 OECD-MA arm’s length principle
  - legal basis in contracting state necessary
  - If an adjustment is made by one state the other state has to make a corresponding adjustment but only if the first adjustment was in line with Art. 9 OECD-MA (arm’s length principle), what may be disputed by the other state
- All legal rules follow the arm‘s-length-principle
- Business transactions between affiliated companies have to be structured as between third parties

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Basics of arm‘s-length-principle

- Partly fictitious, since transactions between affiliated companies follow other rules than those between third parties (e.g.: group backing)
- Direct comparison with third party behaviour rarely possible
- Therefore „notional“ comparison („what would a third party have done if…“
- Functional analysis
  - What function is fulfilled by what company?
  - Functions eg:
    - Production
    - Sales
    - Research/ownership of intangibles
    - storage
- Appropriate reward for functions and risks

Transfer Prices

Methods

- OECD-report 2010
  - Standard methods
  - Profit-oriented methods
  - Global methods
- National Guidelines, eg Germany:
  - Administrative principles 1983
  - Administrative principles Cost Contribution Agreements (1999)
  - Administrative principles Expatriates (2001)
  - Administrative principles Procedures (2005)
  - Regulation re. documentation

Transfer Prices

Internationally used methods:

- Standard methods
  - Comparable uncontrolled price method (CUP)
  - Cost-plus method
  - Resale price method
- Profit-oriented methods
  - Profit-split method
  - Transactional net margin method (TNMM)
- Global method
- Germany: Standard methods and TNMM; Russia: only standard methods
- USA allows global methods, Brazil uses lump-sum standards

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Standard methods

- Comparable uncontrolled price method
  - Direct application of arm‘s-length-principle
  - Comparison with transactions between third parties, between taxpayer and a third party or between affiliate of taxpayer and a third party
  - Intra-group deals are not “comparable” because not “uncontrolled”
  - State-controlled prices are not “uncontrolled”
  - Requires knowledge of all details of the transaction (volume, quality, freight, risk of losses, currency, payment terms, guaranties etc)
  - Full knowledge of details of third-party transaction in practice not available
  - Risk that fiscal authorities use „better knowledge of hindsight“

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Standard methods

- Cost-plus-method
  - Remuneration for producer are costs plus (limited) profit element
  - Applicable for processing agreements, turn-key contracts, professional services
  - Apart from this hardly in line with arm‘s-length-principle
  - Problem: What are „costs“ (eg different depreciation regimes)? generally accepted accounting standards
  - Full costs or only variable costs?

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Standard methods

- Resale-minus method
  - Remuneration for Marketing company are costs plus (limited) profit element
  - Market risk is borne by producer
  - Applicable, if marketing company has the role of a mere agent/ commissionaire
  - Not applicable, if marketing company bears full market risk/fulfills full functions of a trader
  - Not freely exchangeable with cost-plus-method

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Profit-oriented methods

- Profit-split method
  - Profit of a transaction is split between seller and buyer
- Transactional net margin method – TNMM
  - Comparison of the net margin of a transaction between affiliated companies with a margin of a third-party-transaction
  - Frequently used
  - Data banks for margin analysis available
- Wrong conclusions possible if cost level of the partners differs substantially (overheads, inefficiencies)
  - Correctness of this method depends on the issue what factors are included in “margin”
  - If data banks are used, knowledge required how data are computed

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Global methods

- Total profit of a group of companies is allocated to local companies according to a key
  - eg return on investment/capital
  - eg margin as percentage of proceeds
- Global methods are not in line with arm‘s-length-principle, therefore not in line with Art. 9 OECD-MA
- Are used by USA

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Price range

- Special problem if price range exists:
- Average of the prices within the range?
  - Argument: If the tax payer acts in line with the market the agreed prices will in medium/long run equal the average of the market prices
- Prices of second and third quartile?
  - Argument: Prices in the first and fourth quartile are likely to be special cases and therefore not “comparable”
- The price most favourable for the tax payer?
  - Argument: Every price in the price range is a market price and therefore a “comparable” price

Transfer Prices

Transfer of goods

- Comparable uncontrolled price method
- Relevant selling market
- Marketing company as risk taker or agent?
- Losses of a marketing company?
- Change of marketing structure „transfer of functions“
  - Transfer of customer relationships
  - Transfer of profit potential
  - See part 4 “Transfer of Functions”

Transfer Prices

Services

- Comparable prices rarely available (e.g. transport, insurance)
- Other areas: cost plus method
- Group coordination costs
  - Use of group name (not if trade mark)
  - Development of group strategy
  - Administration of associated companies
  - Corporate governance (internal audit?)
  - Appraisal
  - Benefit test

Transfer Prices

Control- and Coordination Centres

- Neither permanent establishment of parent nor of affiliated company (no transfer of mind and management)
- Costs can be charged if the services are of benefit for the affiliated company
- Cost-plus method incl. market-related profit element

Transfer Prices

Intangible assets

- OECD-report distinguishes:
  - Marketing intangibles (trade marks, customer relationships)
  - Trade intangibles (patents, production processes
- Uncontrolled price method
  - Cost-plus not appropriate
  - Resale-minus not possible
  - German fiscal authorities maintain card index for royalties
- Separate company for patent administration
  - Toll research
  - Risk taker
  - Problem: How to transfer intangible assets to the patent administration company?

Transfer Prices

Financing

- Market interests
  - Currency
  - Relevant market
  - Securities
  - Financing period
- Thin capitalisation (Germany):

  Interest expenses are only deductible to the amount of interest income plus 30 % of EBITDA; excess carried forward
- Thin capitalisation (Russia):

  Applicable if non-resident legal entity holds more than 20 % of resident company; equity-debt ration 1:3 (banks and leasing companies: 1:12,5). Excess reclassified as dicvidends

Transfer Prices

Documentation

- Internationally widely used by fiscal authorities
- In principle: Tax payer has to explain what he has done and why; fiscal authorities have the burden of proof
- Documentation requirements
  - Documentation of facts: Type and clauses of transactions
  - Documentation that the arm‘s-length-principle was complied with
- Issues:
  - Has the documentation to be done immediately after the event?
  - Under what circumstances can the fiscal authorities ask for the documentation?
  - Has the documentation to be handed over immediately after the request of tax authorities

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Documentation/Sanctions – Example Germany

- If documentation is not available or not useable:
  - Assumption that due to transfer prices profits have been reduced (change of burden of proof), **and**
  - In case of a price range: use of the most unfavourable price, **and**
  - Surcharge of 5-10 % of additional income
- In case of late handover: 100 € per day, up to a maximum of 1 Mio € (per year, per transaction, per request?)

Transfer Prices

Mutual agreement procedure:

- Legal basis: Art. 25 OECD-MA
- Request has to be put forward within 3 years after the measure resulting in a double taxation
- Inefficient because:
  - Initiation of the process at the discretion of authorities
  - Tax payer is not involved
  - Risk that authorities come to a solution at the cost of the tax payer
  - Takes long times
  - Possibility to agree to disagree
- DTA US-Germany: Arbitration with “first best offer”

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Arbitration procedure:

- Legal basis: EC-convention
- 3 steps:
  - Information
  - Mutual Agreement Procedure: 2 years
  - Arbitration procedure: 6 months
  - Fiscal authorities can accept the arbitration decision or agree within 6 month to another solution
- Arbitration has the character of a legal procedure
- Tax payer is party to the process
- A solution has to be found which avoids double taxation

Transfer Prices

Rulings:

- In OECD-states possible, however costly
- Advanced Pricing Agreements (APA)
  - Agreement with the fiscal authorities that a certain method to calculate transfer prices is valid
  - Can be with more than one fiscal authority (multi-party APA)
- Valid only if actual prices are calculated in accordance with APA
  - APA can lead to additional taxes if not followed: If APA was correct, all other methods are not suitable for the specific case therefore fiscal challenge
- Risks:
  - Content of ruling can be worse than hoped
  - Fiscal authorities are put on the alert
  - Premature information of fiscal authorities

Transfer Prices

Controlled Foreign Companies (CFC):

- Avoidance of profit transfers to companies with reduced functions
- 4 Steps:
  - Companies without economic function: abuse of law
  - Management in Germany: unrestricted taxation
  - Company with reduced function in a low-tax area: CFC rules apply
  - Company with full function: transfer prices
- Transfer pricing rules would be sufficient

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CFC‘s/ legal consequences - Germany:

- CFC must be controlled by German residents
- Passive income as defined by law
- Resident in low-tax-country: tax rate less than 25 %
- Income of CFC is allocated to shareholder as deemed dividend
- Foreign taxes of the CFC can be deducted or credited
- Tax exemption/reduction of tax base available for „normal“ dividends is not applied to „deemed dividend“ of CFC
- However, dividend later actually paid by the CFC is tax-exempt.

Russia:

- No CFC regulation, however currency regulations restricting domestic investors in respect of investments outside Russia have a similar effect.

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ECJ dated 12/9/06 (Cadbury-Schweppes)

- Establishment in another state with the aim at using the beneficial tax system is protected by the freedom of establishment
- Discrimination since profits of a UK based affiliate are not taxed at the level of the parent company
- Only possible justification is prevention of abuse of law
- Establishment of an affiliate in a low tax country is no abuse of law
- However, company must carry out actual and true business activities
  - Can be business relationships to affiliated companies

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ECJ on CFC rules:

- Criteria for abuse of law**:**
  - Material presence
  - Deliveries/performances on own account
  - Activities with added value
- Standardised assumptions possible
- Taxpayer must have the right to prove the contrary
- German CFC-rules to a large extent not in line with EC law, therefore limited application if CFC is located in EC country

Transfer Prices

Transfer of business functions

- Transfer of assets
  - Material assets
  - Immaterial assets
  - Customer relationships
  - Good will
- Transfer of “transfer package”
  - Profit potential
  - Who has the right to tax profit achieved in a low tax/low cost country?