



General Department of Taxation

Transfer Pricing

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Overview of Transfer Pricing



Definition of Transfer Pricing

What is Transfer Pricing?

Prices at which an enterprise transfers physical goods and intangible property or provide services to related enterprises



The main transactions subject to transfer pricing

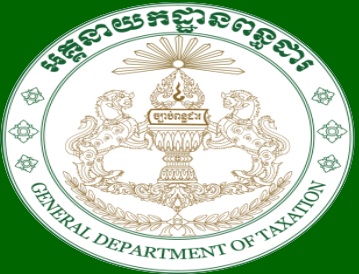
Property	Tangible (Products/Goods)	Import/Export (Price, Rental)
	Intangible (Patent, Trade Mark, Trade Name, Know-how, R&D...)	Royalty fee
Service	Financing	Interest payment
	Intra-group service	Management fee, Marketing fee, Consultant fee, Technical support service... etc.



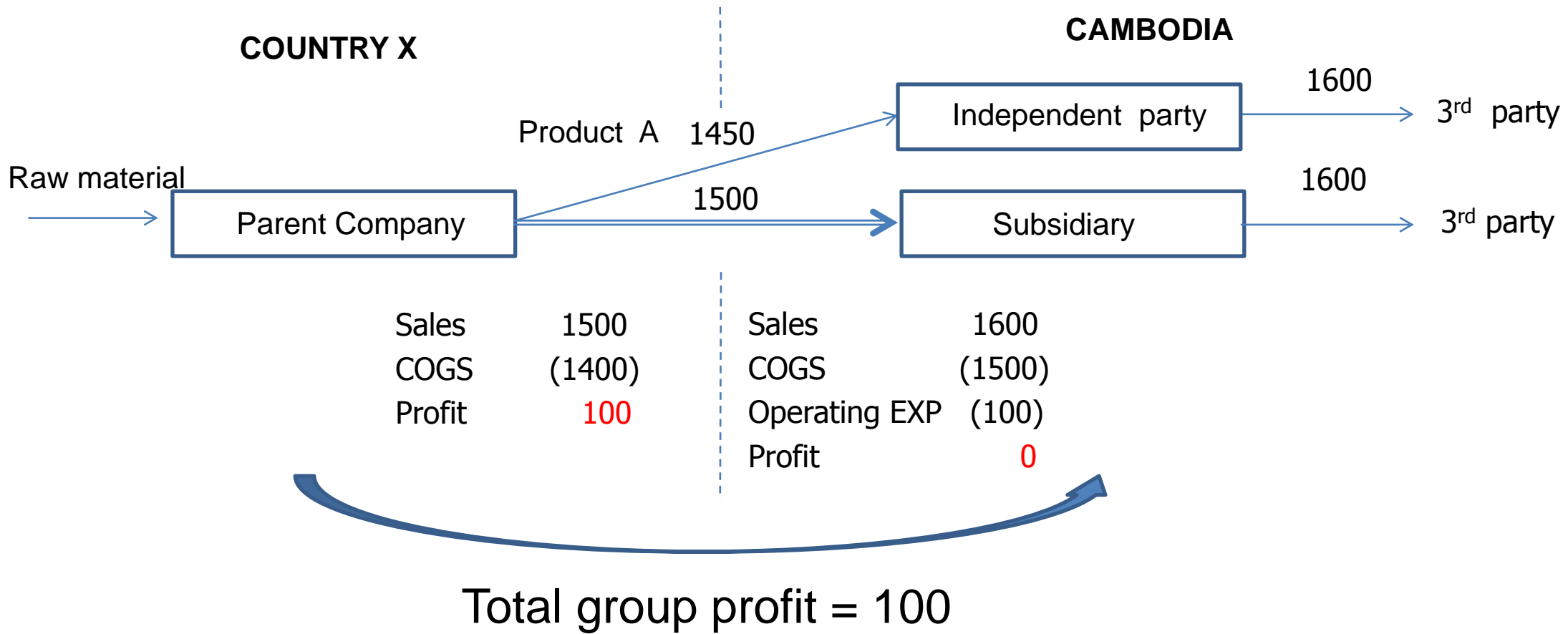
Example of Transfer Pricing

A high-end watch manufacturer in Country X distributes its watches through a subsidiary in Cambodia. It is assumed that the watch costs \$1400 to make and it costs the Cambodia subsidiary \$100 to distribute it. The Parent Company sets a transfer price of \$1500 and the subsidiary sells the watch at \$1600 in Cambodia. Overall, the company has made \$100 in profit, on which it is expected to pay tax. The Parent company also sells this product at \$1450 to independent party.

On the other hand, when the subsidiary in Cambodia is audited by Cambodian tax authority, it is noticed that the distributor itself does not earn a profit: the \$1500 transfer price plus the Cambodia unit's \$100 distribution costs are exactly equal to the \$1600 retail price. Cambodian tax authority considers that the transfer price should be set at \$1450 so that Country X's unit shows the group's \$100 profit that would be liable for tax for both countries.



Example of Transfer Pricing (Con)





Arm's Length Principle



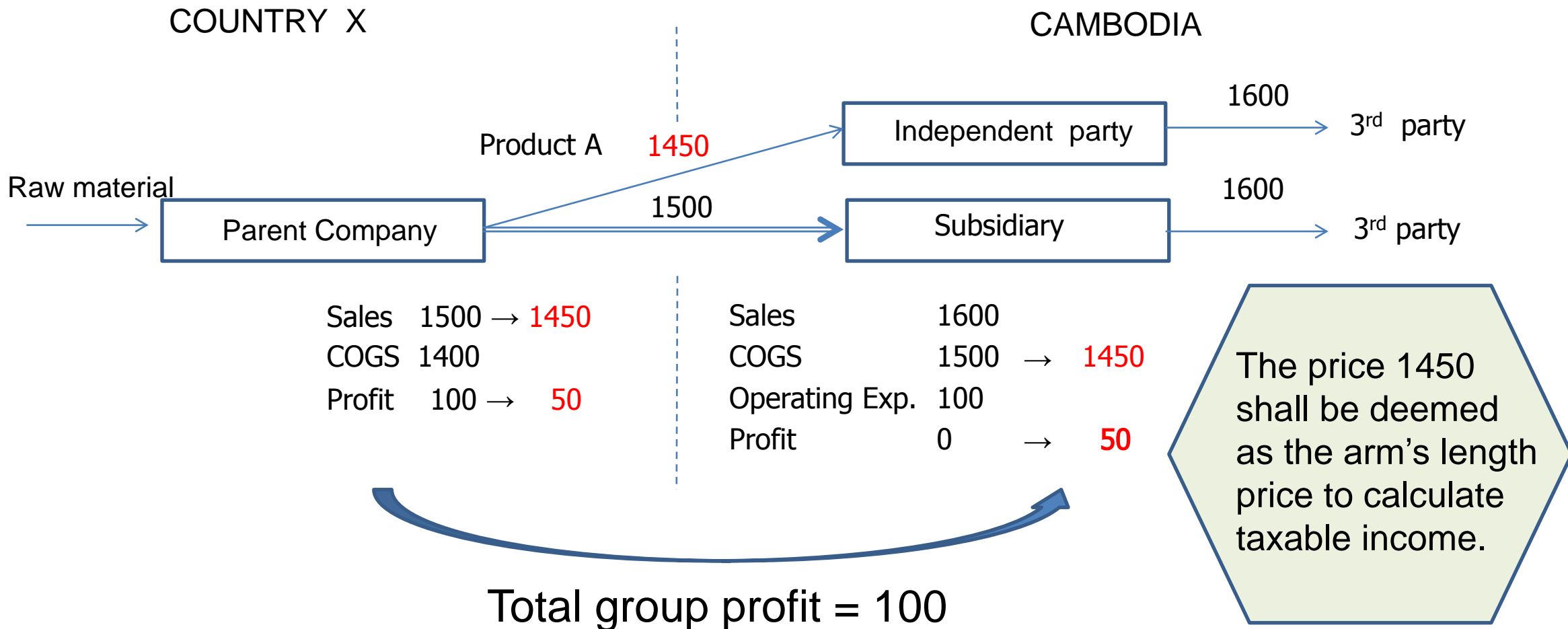
Arm's Length Principle

The price which would have been formed between comparable unrelated parties under comparable circumstance.

- The arm's length principle is the international transfer pricing standard agreed by the OECD Member countries and that is used by both multinational enterprises (MNEs) and over 100 tax administrations in developed, emerging, and developing countries.
- Applying the arm's length principle will give certainty to companies that they will not get taxed twice.



Arm's Length Principle





Comparability Analysis



Comparability Analysis

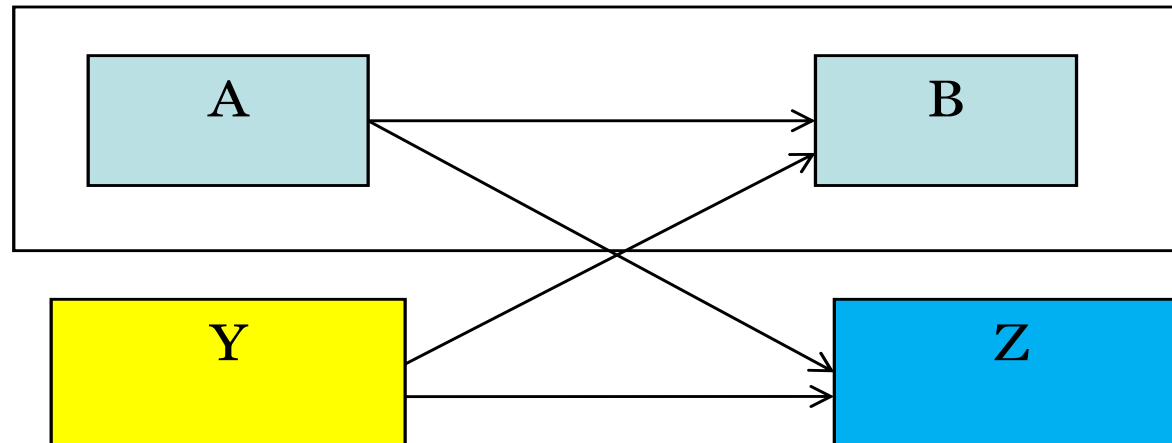
Comparable uncontrolled transactions are broken down into internal and external comparable transactions.

- An internal comparable transaction is a transaction performed by one of the parties to the controlled transaction with an independent party.
- An external comparable transaction is a comparable transaction entered into by two independent enterprises, neither of which is a party to the controlled transaction.



Comparability Analysis

- Internal Comparables
- External Comparables



A – B = Controlled transaction

A-Z and Y-B = Internal Comparables

Y-Z = External Comparables



Factors determining Comparability

1- Characteristics of property or services

- The physical features, quality and Quantity of supply
- The nature and extent of services;
- The form of transaction and type of intangible property

2- Functional analysis

- Functions performed
- Assets used
- Risks assumed (bearing the risk, controlling the risk, and having financial capacity to assume the risk)



Comparability analysis (Cont)

3- Contractual terms

- How are risks, benefits and responsibilities divided
- Analyze terms whether written or oral
- When true terms differ from written terms: then the actual conduct is treated as contractual terms.

4- Economic circumstances

- geographic; market size; competition; substitutes; government intervention

5- Business strategies

- Market penetration
- Innovation
- diversification/ specialization



Comparability analysis (Cont)

An uncontrolled transaction is considered comparable to a controlled transaction if:

- i. There are no differences in transactions being compared that would **materially affect the price**; or
- ii. Reasonably accurate **adjustments** can be performed to account for material differences between the controlled and the uncontrolled transaction(ex: delivery terms, volume of sales)



Transfer Pricing Methods



Transfer Pricing Methods

- Traditional transaction methods:
 - Comparable Uncontrolled Price (CUP)
 - Cost plus method (CPM)
 - Resale price method (RPM)

} Gross profit level indicator
- Transactional profit methods:
 - Transactional Net Margin Method (TNMM)
 - Profit Split method (PSM)

} Net profit level indicator



Comparable Uncontrolled Price

A transfer pricing method that compares **the price for property or services** transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

This method is ideal in a situation where comparable products or services are available, or if reasonably accurate adjustments can be made to eliminate material product or service differences.



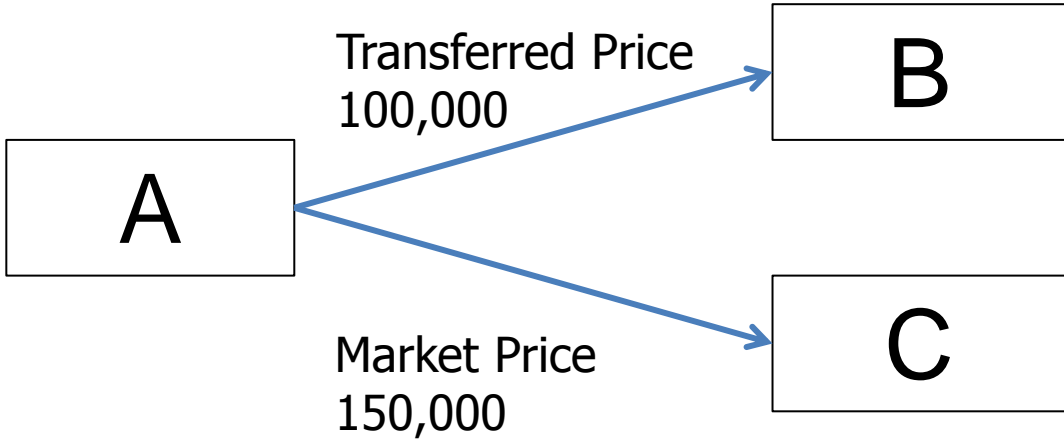
CUP Method

Example:

- Company A is an enterprise that sells 70% of its product A to an overseas related enterprise, Company B, at a price of *R100,000* per unit. At the same time, the remaining 30% of that product is sold to a local independent enterprise, Company C at *R150,000* per unit.
- Suppose that the Product can be found to be comparable in the market.



CUP Method



Company A			
	Initial	Adjustment	Final
Sales	100,000	50,000	150,000
Cost of Goods Sold	(70,000)		(70,000)
Gross profit	30,000		80,000
Other operating expenses	(20,000)		(20,000)
Net profit	10,000		60,000



Applicability of CUP method

Strengths	Weaknesses	Best applied to
<ul style="list-style-type: none">• Most direct and reliable way to apply the arm's length principle• 2-sided analysis• Avoid the issue of tested party selection	<ul style="list-style-type: none">• High degree of product comparability required• In practice, often difficult to find uncontrolled transactions similar enough that no differences have material effect on the price	<ul style="list-style-type: none">• Transactions where the same product is sold to the related enterprise and independent enterprise (s) (internal comparable)• Transactions where an independent enterprise sells the same product as the associated enterprises (external comparable)



Resale price method

- The resale price method consists of comparing the resale margin from reselling the product in a controlled transaction with the resale margin from reselling the product in an uncontrolled transaction.
- The resale price method is generally most appropriate where the transaction involves a sales or distribution function that does not involve the assumption of significant risk or the exploitation of unique and valuable intangibles.



Resale price method

***Functional comparability** is typically more important than product comparability because it is less probable that product will have a material effect on profit margins than on price. One would expect a similar level of compensation for performing similar functions across different activities.

***Accounting consistency** is extremely important in applying the RPM (Do not compare apples with oranges).

For example, the comparable distributors may differ from the related sales company in reporting certain costs (e.g. discounts, transportation costs, insurance and costs of performing the warranty function) as Operation Expense or as COGS.



Resale price method

- **Arm's length price** = Resale price - (Resale price x Resale price margin)

- Where: Resale price margin =
$$\frac{\text{Sales price} - \text{Purchase price}}{\text{Sales price}}$$
$$= \frac{\text{Gross Profit}}{\text{Sales price}}$$

* Resale price margin must be compared to margins earned by other comparable independent enterprises performing similar functions, bearing similar risks and employing similar assets.



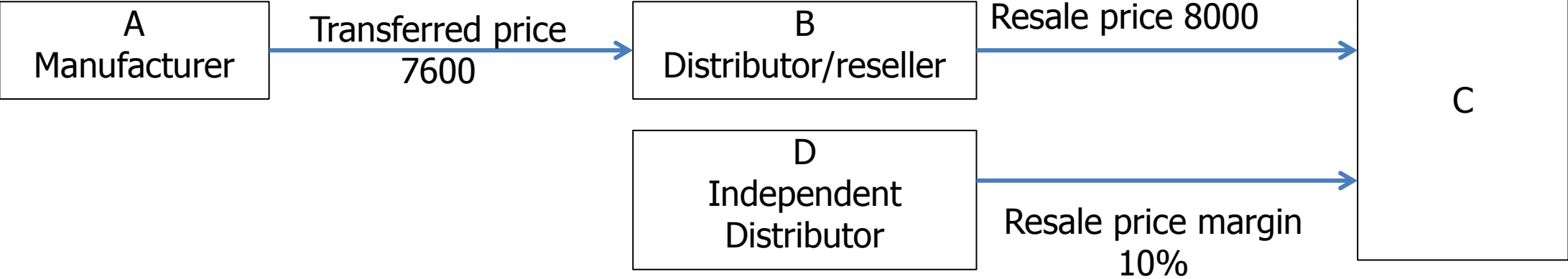
Resale price method

Example 2

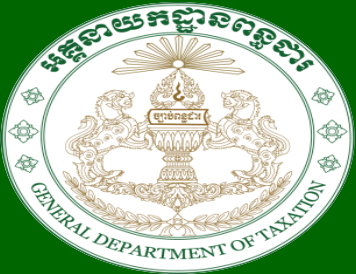
- Company A, which is located overseas, is a multinational enterprise manufacturing a high quality product.
- Company **B** is a *Cambodian* subsidiary enterprise of multinational Company **A**.
- Company C is an independent enterprise in Cambodia.
- Company D is an independent reseller in Cambodia.
- **B** purchases the high quality product from A at R7600 per unit. **B** resells the products to independent enterprise **C** for *R8000* per unit.
- Company B and D perform the comparable resale function in similar circumstance. The gross profit ratio of D's products when sold to C was found to be 10%.



Resale price method



	Initial	Adjustment	Final
Sales	8.000		8.000
Cost of Goods Sold	7.600	(400)	7.200
Gross profit	<u>400</u>		<u>800</u>
Gross Margin	400/8000 = 5%		800/8000 = 10%



Applicability of Resale Price Method

Strengths	Weaknesses	Best applied to
<ul style="list-style-type: none">• Product differences are less significant, i.e. are less likely to have material effect on profit margins than on price	<ul style="list-style-type: none">• Accounting consistency important for comparability purposes=>difficult to find comparable data on GPM for accounting inconsistencies• Resale price method difficult to use when (i) goods are further processed before resale, or (ii) reseller contributes substantially to creation or maintenance of intangible associated with the product (e.g. trademarks, tradenames).	<ul style="list-style-type: none">• Marketing operations (distributor not adding significant value to the product)



Cost Plus Method

The cost plus method consists of comparing the mark up on those costs directly and indirectly incurred in the supply of property or services in a controlled transaction with the mark up on those costs directly and indirectly incurred in the supply of property or services in comparable uncontrolled transactions.



Cost Plus Method

Arm's length price = Costs + (Cost x Cost plus mark-up)

Where:

$$\text{Cost plus mark-up} = \frac{\text{Sales price} - \text{Costs}}{\text{COGS}} = \frac{\text{Gross Profit}}{\text{COGS}}$$

COGS = Costs of Goods Sold

*Cost plus mark-up must be compared to markups earned by other comparable independent enterprises performing similar functions, bearing similar risks and employing similar assets.



Cost plus method

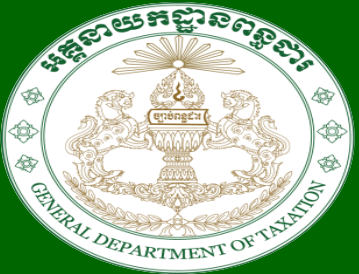


Sales price	=	500
<u>Cost of Goods Sold</u>	=	<u>400</u>
Gross Profit	=	100

-The appropriate AL's gross profit mark up is 40%

What is the arm's length price?

- Gross profit mark up 40% => Gross profit = $400 \times 40\% = 160$
- Arm's length price = $400 + 160 = 560$ (not 500)



Applicability of Cost Plus Method

Strengths	Weaknesses	Best applied to
<ul style="list-style-type: none">• Fewer comparability adjustments needed compared to the CUP method to account for product differences, because focus is on functions performed• Based on internal costs	<ul style="list-style-type: none">• Difficult to locate comparable product intangibles for transactions involving a fully-fledged manufacturer (complex party)• Costs incurred may not always be determinant of profit level	<ul style="list-style-type: none">• Contract manufacturer which does not own product intangibles and incurs little risk



Transactional Net Margin Method(TNMM)

- TNMM is one of the TP method which is used in replace of the Resale Price Method or the Cost Plus Method in case where the gross profit margin or the gross profit mark up is not reliable for comparability, especially when there is different accounting treatment.



Transactional Net Margin Method(TNMM)

Consider the example:

- Parent Company sells cameras to Subsidiary which resells the cameras to third Party. Assume that **Parent Company is the core complex party**, controlling a variety of Technology and operating intangibles. RPM is more appropriated because the sale company is **the least complex party**, But the **TNMM may be more reliable if there is different accounting treatment**
- For TNMM method, the operating expense and the resale price are known.



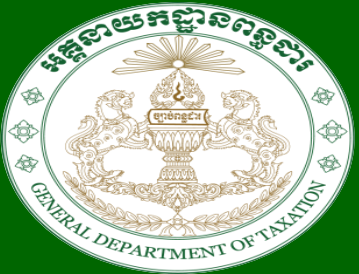
Transactional Net Margin Method(TNMM)

The appropriate AL's net profit margin is 15%

What is the arm's length price?

1. Net profit margin 15%
=> Net Profit= $10000 \times 15\% = 1500$
2. Gross Profit = $1500 + 2800$
= 4300
3. AL's price = $10000 - 4300 = 5700$
(not 7000)

Income statement of Subsidiary		
Sale price	=	10,000
<u>COGS</u>	=	<u>5,700</u>
Gross profit	=	4,300
Operating exp	=	<u>2,800</u>
Net profit	=	1,500



Applicability of TNMM method

Strengths	Weaknesses	Best applied to
<ul style="list-style-type: none">• Net profit indicators (e.g. return on assets, operating profit to sales, etc.) are less affected by transactional differences than price	<ul style="list-style-type: none">• Net profit indicator can be influenced by factors that would not have a significant effect on price or gross margins, making accurate and reliable determinations of arm's length net profit indicators difficult	<p>Cost Plus Analogue:</p> <ul style="list-style-type: none">• (Contract) Manufacturer• Service Provider not adding significant unique intangibles <p>Resale Price Analogue:</p> <ul style="list-style-type: none">• Distributor not adding significant value to the product



Profit split method

Typically applied when both sides of the controlled transaction contribute significant intangible property.

For example:

Co X manufactures components using valuable intangible property and sells these components to a related Co Y which uses the components and also uses valuable intangible property to manufacture final products and sells them to customers.



Method to allocate the profit

2 Methods:

1. Contribution analysis: allocate on the basis of the relative value of functions performed by those related enterprises in addition with the external market data (how independent enterprises allocate)
2. Residual analysis: allocate based on a 2-step approach:
 - Allocate the basic return (arm's length) for comparable manufacturing and distribution functions (TNMM is used in practice)
 - Allocate the residual profit: based on the relative value of each enterprise contributions of intangible property (not depend on the use of comparables). Approaches to determine the relative value of each contributions are based on facts and circumstances.



Example of Profit Spit Method

	COMPANY A	COMPANY B
Profit	30	52
Sale	1,000	1,600

STEP 1: Calculating profit margin and the residual profit based on the function and risk analysis and doing the comparable analysis.

For eg: Company B's comparable enterprise profit margin is 2%

Then Company B's basic profit is $[1,600 \times 2\% = 32]$

As the same way Company A's basic profit is $[1,000 \times 2\% = 20]$

\Rightarrow Total basic profit = $32 + 20 = 52$

So, residual profit = $82 - 52 = 30$

This residual profit 30 will to spit



Example of Profit Split Method (Cont)

STEP 2: Spit the residual profit on the contribution (* Intangibles) .

Suppose Company A own Intangible 40% while Company B own intangible 60%.

Then Company A get $[30 \times 40\% = 12]$

Company B get $[30 \times 60\% = 18]$

Finally, for Company A get basic profit 20 and residual profit 12 **total = 32** while
Company B get basic profit 32 and residual profit 18 **total = 50**



Applicability of Profit Split method

Strengths	Weaknesses	Best applied to
<ul style="list-style-type: none">• Suitable for highly integrated operations• Suitable in cases where the traditional methods prove inappropriate due to a lack of comparable transactions	<ul style="list-style-type: none">• Difficult to measure combined revenue and costs for all associated enterprises participating in the controlled transactions, which would require stating books and records on a common basis and making adjustments in accounting practices and currencies.	<p>Residual Profit Split (Residual Analysis):</p> <ul style="list-style-type: none">• Transactions where both parties make unique and valuable contributions (e.g. intangibles) to the transaction



Intangible Property



Intangible Property

An intangible asset is something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.

Types of intangible property include patents, know-how, trademarks, brand names, copyrights, registered designs, franchises, licenses, literary and artistic property rights, and other similar items, which are valued for their intellectual or intangible content.



Intangible Property

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Intangible Property

The transfer of intangibles between related enterprises may be carried out in the following manner:

- Outright sale or transfer either for consideration, or by way of gift, or capital contribution;
- In the form of lease or license where royalty is paid to the owner.



Intangible Property

A comparability analysis must take into account:

- The expected benefits from the intangible property
- In the case of a patent, the nature and duration of the patent, the patent laws in the relevant countries, the value (of the final product) that is attributable to the patent
- Marketing intangibles (e.g. trademark)
 - The value added by the trademark
 - Consumer acceptability, geographical significance, market share, sales volumes etc.;



Intangible Property

Identify the economically significant risks to determine the IP ownership as following:

- Development
- Enhancement
- Maintenance
- Protection
- Exploitation



Intra-group Services



Intra-group services

In many cases, a wide range of services are provided for intra-group use as following:

- Research and Development
- Administrative service
- Technical assistance,
- Financial or other commercial services



Intra-group services

- The main issues with regard to intra-group services are:
- Whether intra-group services have been provided
 - If so, whether the intra-group charge for the services are at arm's length prices.



Thank you !!