Transfer Pricing

Presented by:
- Mr.Traing Lay
- Mr. Chea Chantra

18 January 2018

All rights reserved by General Department of Taxation
Content

1- Overview of Transfer Pricing
2- Arm’s Length Principle
3- Comparability Analysis
4- Transfer Pricing Methods
5- Intangible Property
6- Intra-group services
Overview 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

<table>
<thead>
<tr>
<th>Property</th>
<th>Tangible (Products/Goods)</th>
<th>Import/Export (Price, Rental)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intangible (Patent, Trade Mark, Trade Name, Know-how, R&amp;D...)</td>
<td>Royalty fee</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Service</th>
<th>Financing</th>
<th>Interest payment</th>
</tr>
</thead>
</table>
| Intra-group service      | Management fee, Marketing fee, Consultant fee, Technical support service… etc.
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)

<table>
<thead>
<tr>
<th>COUNTRY X</th>
<th>CAMBODIA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parent Company</td>
<td>1500</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>1500</td>
</tr>
<tr>
<td>Sales</td>
<td>1500</td>
</tr>
<tr>
<td>COGS</td>
<td>(1400)</td>
</tr>
<tr>
<td>Profit</td>
<td>100</td>
</tr>
<tr>
<td>Raw material</td>
<td></td>
</tr>
</tbody>
</table>

3rd party

Total group profit = 100
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

COUNTRY X

Parent Company

Raw material

Sales 1500 → 1450
COGS 1400
Profit 100 → 50

Product A 1450

1500

Subsidiary

Independent party

CAMBODIA

1600

3rd party

1600

3rd party

The price 1450 shall be deemed as the arm’s length price to calculate taxable income.

Total group profit = 100

The price 1450 shall be deemed as the arm’s length price to calculate taxable income.

Total group profit = 100
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
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)

• Transactional profit methods:
  – Transactional Net Margin Method (TNMM)
  – Profit Split method (PSM)
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.
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

<table>
<thead>
<tr>
<th>Company A</th>
<th>Initial</th>
<th>Adjustment</th>
<th>Final</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>100,000</td>
<td>50,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>(70,000)</td>
<td>(70,000)</td>
<td></td>
</tr>
<tr>
<td>Gross profit</td>
<td>30,000</td>
<td>80,000</td>
<td></td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>(20,000)</td>
<td>(20,000)</td>
<td></td>
</tr>
<tr>
<td>Net profit</td>
<td>10,000</td>
<td>60,000</td>
<td></td>
</tr>
</tbody>
</table>

Transferred Price: 100,000
Market Price: 150,000
### Applicability of CUP method

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
<th>Best applied to</th>
</tr>
</thead>
<tbody>
<tr>
<td>Most direct and reliable way to apply the arm’s length principle</td>
<td>High degree of product comparability required</td>
<td>Transactions where the same product is sold to the related enterprise and independent enterprise (s) (internal comparable)</td>
</tr>
<tr>
<td>2-sided analysis</td>
<td>In practice, often difficult to find uncontrolled transactions similar enough that no differences have material effect on the price</td>
<td>Transactions where an independent enterprise sells the same product as the associated enterprises (external comparable)</td>
</tr>
<tr>
<td>Avoid the issue of tested party selection</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- **Strengths**
  - Most direct and reliable way to apply the arm’s length principle
  - 2-sided analysis
  - Avoid the issue of tested party selection

- **Weaknesses**
  - 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

- **Best applied to**
  - 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)
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.
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

A Manufacturer

Transferred price 7600

B Distributor/reseller

Resale price 8000

D Independent Distributor

Resale price margin 10%

<table>
<thead>
<tr>
<th></th>
<th>Initial</th>
<th>Adjustment</th>
<th>Final</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>8,000</td>
<td></td>
<td>8,000</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>7,600</td>
<td>(400)</td>
<td>7,200</td>
</tr>
<tr>
<td>Gross profit</td>
<td>400</td>
<td></td>
<td>800</td>
</tr>
<tr>
<td>Gross Margin</td>
<td>400/8000 = 5%</td>
<td></td>
<td>800/8000 = 10%</td>
</tr>
</tbody>
</table>
## Applicability of Resale Price Method

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
<th>Best applied to</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Product differences are less significant, i.e. are less likely to have material effect on profit margins than on price</td>
<td>• Accounting consistency important for comparability purposes =&gt; difficult to find comparable data on GPM for accounting inconsistencies</td>
<td>• Marketing operations (distributor not adding significant value to the product)</td>
</tr>
<tr>
<td></td>
<td>• 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).</td>
<td></td>
</tr>
</tbody>
</table>
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:
Cost plus mark-up = \frac{\text{Sales price} - \text{Costs}}{\text{COGS}} = \text{Gross Profit}

\text{COGS} = \text{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.*
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*40% = 160
- Arm’s length price = 400 + 160 = 560 (not 500)
### Applicability of Cost Plus Method

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
<th>Best applied to</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Fewer comparability adjustments needed compared to the CUP method to account for product differences, because focus is on functions performed</td>
<td>• Difficult to locate comparable product intangibles for transactions involving a fully-fledged manufacturer (complex party)</td>
<td>• Contract manufacturer which does not own product intangibles and incurs little risk</td>
</tr>
<tr>
<td>• Based on internal costs</td>
<td>• Costs incurred may not always be determinant of profit level</td>
<td></td>
</tr>
</tbody>
</table>

- Fewer comparability adjustments needed compared to the CUP method to account for product differences, because focus is on functions performed
- Based on internal costs
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.
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.
Subsidiary company purchase cameral from parent company at 7000 per unit and sell it to third party at 10,000.

**Income statement of Subsidiary**

- **Sale price** = 10,000
- **COGS** = 7,000
- **Gross profit** = 3,000
- **Operating expenses** = 2,800
- **Net profit** = 200
The appropriate AL’s net profit margin is 15%

What is the arm’s length price?
1. Net profit margin 15%
   => Net Profit = 10000*15% = 1500
2. Gross Profit = 1500 + 2800
   = 4300
3. AL’s price = 10000 - 4300 = 5700
   (not 7000)

Income statement of Subsidiary

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale price</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>COGS</strong></td>
<td>5,700</td>
</tr>
<tr>
<td>Gross profit</td>
<td>4,300</td>
</tr>
<tr>
<td>Operating exp</td>
<td>2,800</td>
</tr>
<tr>
<td>Net profit</td>
<td>1,500</td>
</tr>
</tbody>
</table>
Applicability of TNMM method

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
<th>Best applied to</th>
</tr>
</thead>
</table>
| • Net profit indicators (e.g. return on assets, operating profit to sales, etc.) are less affected by transactional differences than price | • 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 | **Cost Plus Analogue:**  
• (Contract) Manufacturer  
• Service Provider not adding significant unique intangibles  
**Resale Price Analogue:**  
• Distributor not adding significant value to the product |
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.
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

<table>
<thead>
<tr>
<th>COMPANY A</th>
<th>COMPANY B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit</td>
<td>30</td>
</tr>
<tr>
<td>Sale</td>
<td>1,000</td>
</tr>
</tbody>
</table>

**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 X 2% = 32]

As the same way Company A’s basic profit is [1,000 X 2% = 20]

⇒ Total basic profit = 32 + 20 = 52

So, residual profit = 82 - 52 = 30

This residual profit 30 will to spit
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

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
<th>Best applied to</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Suitable for highly integrated operations</td>
<td>• 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.</td>
<td></td>
</tr>
<tr>
<td>• Suitable in cases where the traditional methods prove inappropriate due to a lack of comparable transactions</td>
<td></td>
<td><strong>Residual Profit Split (Residual Analysis):</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Transactions where both parties make unique and valuable contributions (e.g. intangibles) to the transaction</td>
</tr>
</tbody>
</table>
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.
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.
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.
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
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
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 !!