Transfer Pricing and Tangible Goods

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Transfer pricing, in a nutshell, is the determination of prices on the exchange of goods or services between related parties. These transfers also are referred to as intercompany transactions.

Prices paid for the purchase and sale of tangible goods are one of the main types of intercompany transactions and are subject to transfer pricing principles. Most countries require taxpayers to demonstrate that their intercompany transactions are "at arm's length"—meaning the price charged in a controlled transaction—a transaction between related parties—is the same as that charged between two unrelated parties.

Transfer Pricing Methods

The U.S. transfer pricing regulations and the OECD transfer pricing guidelines specify which transfer pricing methodologies can be used to arrive at the most appropriate method. Transfer pricing methods are a mechanism to determine the arm's length price.

The OECD recommends using the "most appropriate" transfer pricing method based on the circumstances of the controlled transaction. U.S. transfer pricing regulations follow the "best method" rule, which requires the use of the arm's length principle.

Traditional transaction methods include the comparable uncontrolled price method, resale price method, and cost-plus method. Transactional profit methods include the profit-split method and transactional net margin method, also known as the comparable profits method in the U.S.. The U.S. regulations also allow for the use of unspecified methods.

Transfer Pricing Methods Explained

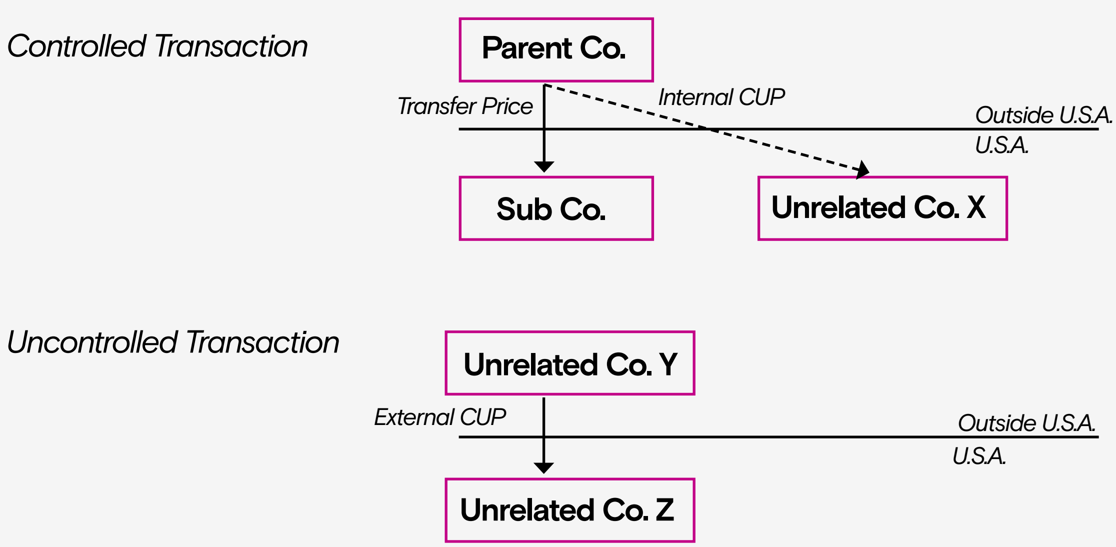
Comparable Uncontrolled Price Method (CUP): The comparable uncontrolled price method compares the price for tangible goods transferred in a controlled transaction to the price of those transferred in a comparable uncontrolled transaction. This method is widely considered the most reliable method when you have access to high-quality, comparable uncontrolled transaction data.

A transaction is considered comparable if the difference between the transactions or parties being compared doesn't have a material effect on price. A transaction is also deemed comparable if adjustments can be made to eliminate the material effect of any differences.

Transactions must be extremely similar to be considered comparable under this method. This method is the most direct, and it's the one tax authorities around the world tend to prefer.

Comparable Uncontrolled Price Method (CUP)

- Two types of CUPs available: Internal CUP and External CUP
- A diagram showing internal CUP and External CUP is presented below



Resale Price Method (RPM): The resale price method compares the resale gross margin earned by a related party with the resale gross margin earned by comparable uncontrolled distributors.

This is the preferred method for distributors that buy finished goods from an entity in the group and resell them to third parties without altering the goods to add value before resale.

Under the RPM, comparability is less dependent on strict product comparability, and additional emphasis is placed on the similarity of functions performed and risks assumed. The uniqueness of each transaction makes it very difficult to meet the resale price method requirements.

Resale Price Method

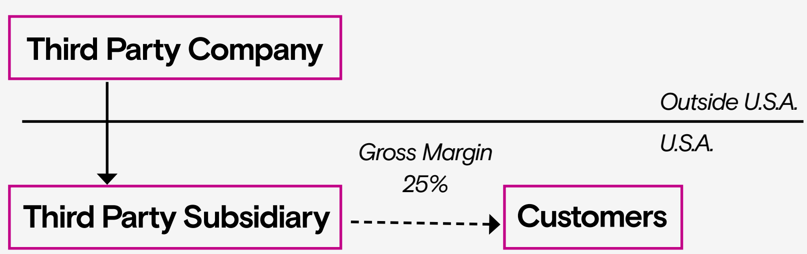
- An example presenting application of resale price method is below:

Controlled Transaction

Price paid by Sub Co. to Parent Co. is considered to be at arm's length if Sub co. earned 25% gross margin on its tangible goods

In the example, Sub Co. earned a gross margin of 25% on its resale price and hence is considered at arm's length price

Uncontrolled Transaction

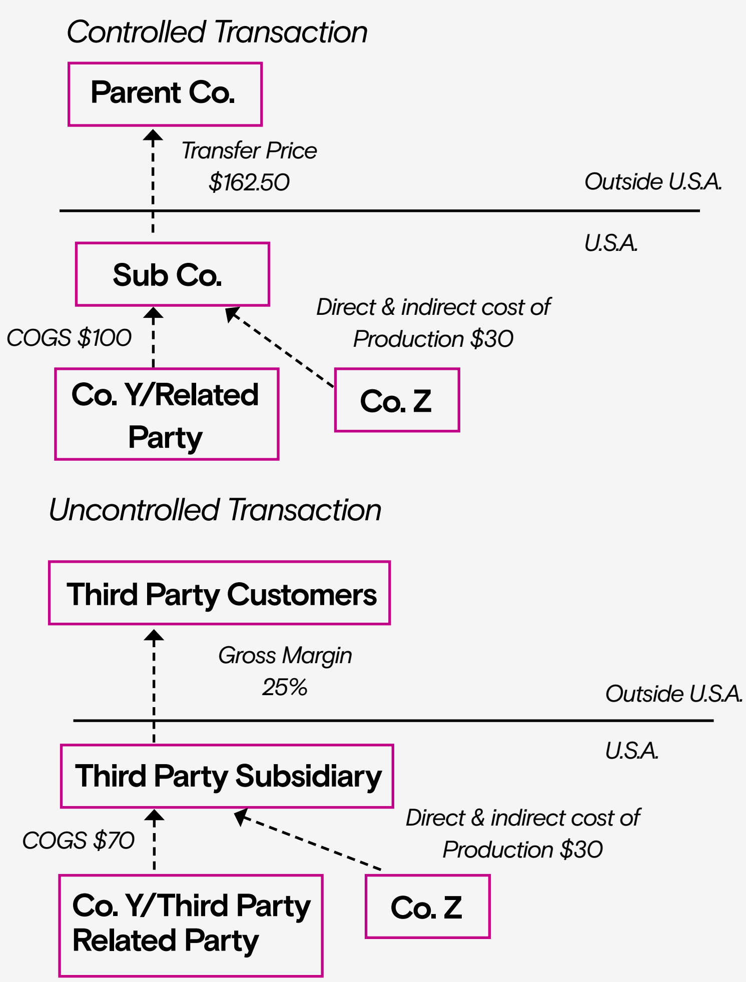


Cost-plus Method (CP): The cost-plus (CP) method compares and identifies the mark-up earned on direct and indirect costs incurred with comparable independent companies. It's a preferred method for semi-finished goods sold between related parties, contract/toll manufacturing arrangements, and long-term buy/supply arrangements.

The method should be applied in cases involving manufacturing, assembling, or producing tangible goods sold to related parties. Functional comparability is the most important factor in choosing this method.

Cost-Plus Method

- A diagram showing application of Cost-Plus Method is presented below:



Price paid by Parent Co. to Sub. Co. is at arm's length if Sub Co. earned 25% gross margin

In the example, Sub Co. earned a gross margin of 25% on its cost hence is at arm's length price

Profit-split Method (PS): The profit split (PS) method is used in cases involving the transfer of intangibles or where there are multiple international transactions that cannot be evaluated separately. It calculates the combined operating profit resulting from an intercompany transaction based on the relative value of each related party's contribution to the operating profit.

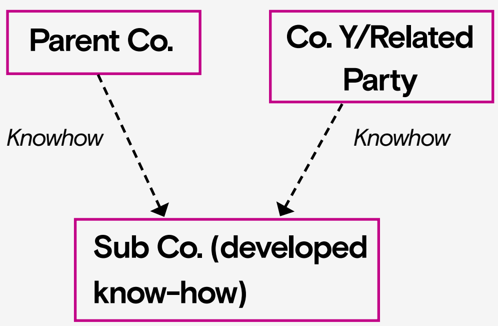
This method evaluates the allocation of combined profit/loss in controlled integrated transactions. The contribution is determined by functions performed, risk assumed, and resources employed.

There are two types of profit split methods: the comparable profit split method and the residual profit split method.

Profit Split Method

- A diagram showing application of Profit Split is presented below:

Controlled Transaction



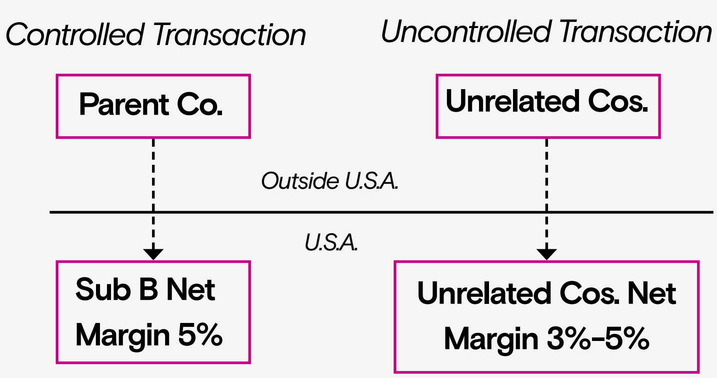
- Indentify comparable transactions for every related party involved in the transaction (i.e., Parent Co., Co. Y, and Sub Co.)
- Determine net profit earned by comparable companies and attribute profits to each related party involved in the transaction
- Allocate the super normal profit/loss to each related party involved (i.e., Parent Co., Co. Y, and Sub Co.) on the basis of their relative contribution

Comparable Profits Method (CPM)/Transactional Net Margin Method (TNMM): The comparable profits method (CPM) / transactional net margin method (TNNM) compares the net profit margin from comparable uncontrolled transactions or companies with the net profit margin of controlled transactions or companies. Net profit margin is computed with reference to cost, sales, or any other relevant profit level indicator, such as operating assets.

It's the most commonly used transfer pricing method because it doesn't require the same comparable uncontrolled prices and gross margin data required by other methods—such as the resale price method or the cost-plus method. The method focuses on finding a broad level of product comparability or a high level of functional comparability.

The CPM/TNMM is applicable for most types of transactions and is often used to supplement a transfer pricing analysis that uses other methods.

Comparable Profits Method (CPM)/Transactional Net Margin Method (TNMM):



- The arm's length price for the related party transaction between Parent Co., and Sub B will be based on the adjusted net margin of the uncontrolled transactions (i.e., 3%-5%)

Unspecified Methods

Unspecified methods are permitted under US law if the OECD's recommended methods aren't appropriate for a particular transaction. Unspecified methods are somewhat of a last resort—to be used only if the traditional transactional and profit-based methods can't be used.

A method's reliability will be affected by the data's reliability and assumptions that were used to apply the method, including any projections that were used.

Best Method Rule / Most Appropriate Method

There are four critical factors to keep in mind when selecting the best method, according to the US transfer pricing regulations, namely, the degree of comparability between the controlled transaction and uncontrolled transaction, the quality and quantity of data, assumptions used in the analysis, and the sensitivity of results to data deficiencies.

The most appropriate method under the OECD guidelines recommends selecting the method based on the circumstances of the transaction. The taxpayer should look at each method's respective strengths and weaknesses, the nature of the controlled transaction (determined by performing a functional analysis), and the availability and reliability of information (in particular for uncontrolled comparables).

Transfer pricing methods are one of the most commonly challenged parts of documentation, so choosing the most organic one is critical. Companies should carefully determine the "best method" or the "most appropriate method." Taxpayers can refer to the US transfer pricing regulations and the OECD guidelines for detailed guidance on factors to consider in determining comparability of uncontrolled transactions.

Using a particular transfer pricing method can result in a range of comparable prices. Companies should use discretion when setting prices within the range to achieve cost minimization objectives.

Taxpayers must provide contemporaneous documentation justifying the transfer pricing method selected along with mandatory specified information, according to the respective country regulations.

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As CrossBorder Solutions, Mimi Song is responsible for managing client relationships and ensuring the successful completion of all work. At the original iteration of CrossBorder Solutions, she served as Vice President of Professional Services.

Following the sale to Thomson Reuters, Song was a Vice President at Duff & Phelps and served as the Head of Transfer Pricing at the Bank of Tokyo-Mitsubishi UFJ.

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