LOYENS LOEFF

Loyens & Loeff Transfer Pricing series

The Arm's Length Principle

June 16, 2022

What we heard from Brazilian experts

From a practical perspective, in a multinational context, could you please share with us some issues current faced due to the differences in the TP system?

“The fact that the legislation sets forth fixed margins sometimes prevents Brazil to efficiently participate in global value chains. In practice, prices are set globally, and most of the countries follow OECD. It is not rare that the presumed margins do not reflect reality and adjustments have to be made in Brazil. For our products a 30% margin is usually not realized.

Additionally, for many types of transactions, such as those involving intangibles, there are no clear methods available”

Bruna Gentile
Dow - Latin America Senior Tax Director

Based on your current contact with OECD transfer pricing standards, what do you expect to be some of the challenges?

“The uncertainty regarding how to interpret the arm’s length principle is definitely something that comes to my mind. Brazil has a long history of controversy, and one may wonder if the adoption of the the arm’s length principle would lead to more litigation.

Practically speaking, how can one select the ‘right’ method? Currently, taxpayers are free to select the best method, but it seems this is not the case under OECD standards. Currently, we know what we need, but the new system will like require new capabilities and tools.”

Definitions

Transfer pricing

A transfer price is the price of goods and services that are exchanged between affiliated entities (and/or permanent establishments) under common control (associated enterprises). For example, if a parent company renders services or sells goods to its subsidiary.

In taxation, transfer pricing rules set prices for transactions between associated enterprises.

The Arm's Length Principle

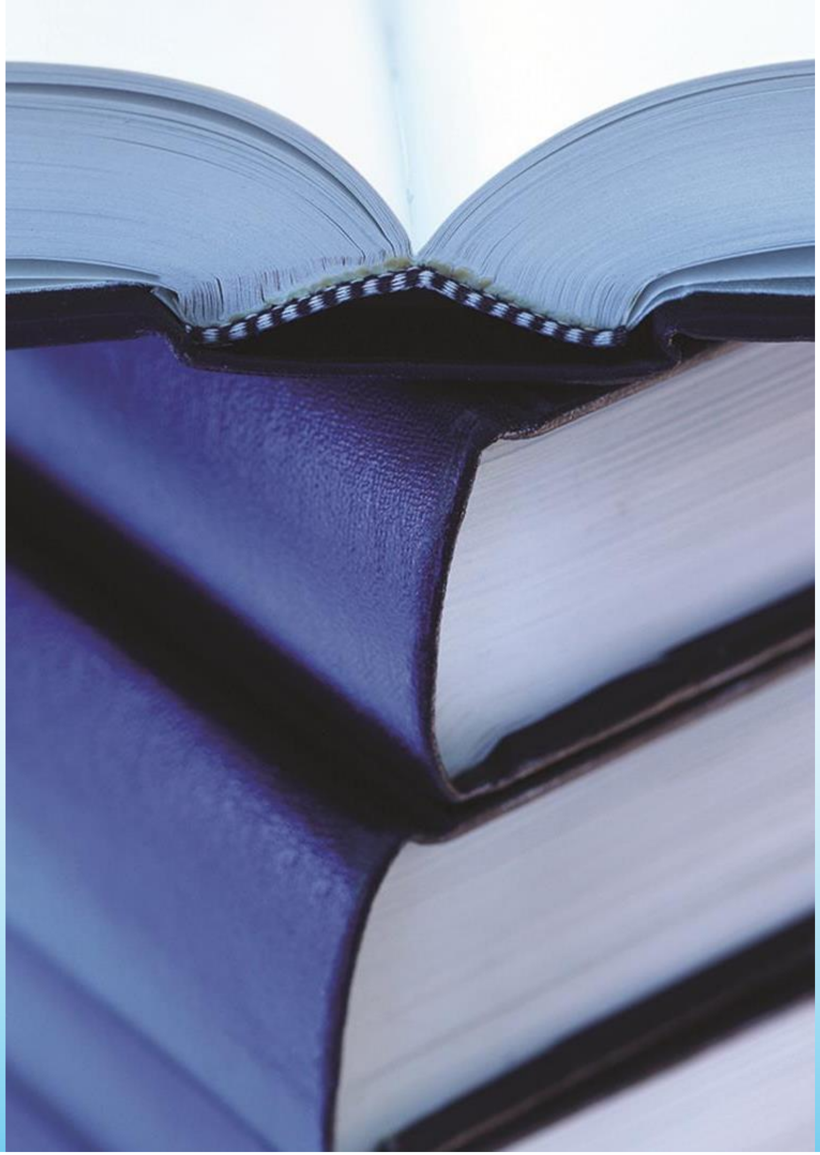
The Arm's Length Principle is the international transfer pricing standard as agreed upon by OECD member countries. The principle states that the price agreed in a transaction between two related parties **must be the same as the price agreed in a comparable transaction between two unrelated parties.**

The Arm's Length Principle is codified in **Article 9** of the OECD Model Tax Convention as follows:

"Where (..) conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

OECD TP Guidelines

- The At Arm's Length Principle is elaborated in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022 (the OECD TP Guidelines).
- The OECD TP Guidelines provide a non-binding interpretation of the arm's length principle which is endorsed and recommended by OECD member states. The OECD TP Guidelines are a revision of the OECD Report Transfer Pricing and Multinational Enterprises (1979).
- They were approved in their original version by the Committee on Fiscal Affairs on 27 June 1995 and by the OECD Council for publication on 13 July 1995.
- The OECD TP Guidelines were supplemented and modified upon multiple occasions.



Important revisions of the TP Guidelines

1997

Report on cost contribution arrangements

2010

Report on transfer pricing aspects of business restructuring

2015

Report on BEPS Actions 8-10 Aligning Transfer Pricing Outcomes with Value Creation and the Report on BEPS Action 13, Transfer Pricing Documentation and Country-by-Country Reporting

2018

Report on the guidance for tax administrations on the application of the approach to hard-to-value intangibles / revision of profit split method

2020

Report on transfer pricing aspects of financial transactions

"These guidelines will continue to be supplemented with additional guidance addressing other aspects of transfer pricing and will be periodically reviewed and revised on an ongoing basis."

- TP Guidelines, Foreword, p. 5

Additional guidance

The Global Anti-Base Erosion (GloBE) Proposal under Pillar Two

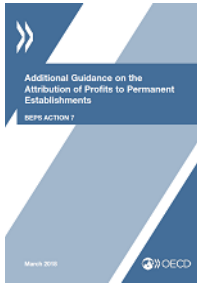
2019

Guidance on Country-by-Country Reporting

2019

2018

Guidance on the Attribution of Profits to a Permanent Establishment



2019

A "Unified Approach" under Pillar One

OECD Guidelines - Chapters

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Chapter I	The Arm's Length Principle
Chapter II	Transfer Pricing Methods
Chapter III	Comparability Analysis
Chapter IV	Administrative Approaches to Avoiding and Resolving Transfer Pricing Disputes
Chapter V	Documentation
Chapter VI	Special Considerations for Intangibles
Chapter VII	Special Considerations for Intra-Group Services
Chapter VIII	Cost Contribution Agreements
Chapter IX	Transfer Pricing Aspects of Business Restructurings
Chapter X	Transfer Pricing Aspects of Financial Transactions

How to conduct a TP analysis: an overview

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How to establish an Arm's Length Transfer Price

Accurate Delineation of the Transaction (85%)
(Comparability Analysis)

Contractual Terms, decisive unless
- Actual conduct deviates from terms
- No control over risk & capacity to absorb
- Transaction cannot be found between unrelated parties & virtually no pricing possible

Functional Analysis
- Activities: who does what?
- Assets: what assets are used?
- Risks: which party assumes the risk?
  - Significant risks only
  - Allocation to party with control over risk (functionality)

Characteristics Goods & Services
- Quality (perception)
- Commodities
- Warranties, etc.

Economic Circumstances
- Location
- Economic growth
- Competition
- Currency
- Price level, competitive market, etc.

Business Strategy
- Where on S-curve?
- Marketing?
- Scalability?

Establish Transfer Pricing Method (10%)

Traditional methods
Two sided analysis
- CUP (Preferred, but limited application)
  - Internal CUP (Related-Unrelated)
  - External CUP (Unrelated-Unrelated)
- Resale Minus (sales activities)
- Cost plus (manufacturing & services)

Difficulty: measures gross margin, often inaccurate

Transactional Profit methods
One sided ("tested party")
- TNMM with Profit Level Indicator
  - Sales
  - Cost (manufacturing & services)
  - Return on Assets (lease, rent, etc.)
  - Other

  Advised for routine functions (no intangibles)

Advantage: measures net margin, less dependent on line item categories
- (Residual) Profit Split
  Advised for complex functions
  - Unique situations
  - Intangibles from two parties
  - Shared entrepreneurial functions

Selection criteria
- (Sensitivity of outcome to) comparability factors
- Reliability of information

Set or Evaluate Transfer Price (5%)

Choose Database
- Amadeus (services, manufacturing)
- Bloomberg (financial transactions)
- RoyaltyStat (licensing)

Define search criteria
- Exclude inaccurate companies (related entities, non-performing)
- Include companies based on comparability factors
  - Functions
  - Characteristics
  - Economic circumstances
  - Business Strategy

Review selected companies (manual)
- Websites
- Annual accounts
- Business brochures
- Business magazines

Statistical analysis
- Median (set TP)
- Interquartile (evaluate TP)

Functional Analysis

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Contract vs. Conduct

The TP Guidelines emphasize the need to accurately delineate a transaction so that the **conduct** of parties will **replace contractual arrangements** where they do not align with each other. Transactions will be priced based on **functions** performed, **risks** assumed, and **assets** used by the involved parties

Functions

Actual and factual contribution to value creation is crucial. Capital without functionality will not be allocated more than a **risk-free return**, assuring that no premium returns will be allocated to cash boxes without relevant **substance**

Risks

Risk is solely allocated to parties which have the **financial capacity** to assume the risks and parties which can **control the risks.**

Disregarding transactions

Tax administrations may **disregard transactions** when transactions are considered **commercially irrational**.

Importance of decision-making functions

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Decision-making functions

The TP Guidelines state that mere legal ownership of an intangible does not by itself confer any right to the return from its exploitation. Instead, the legal owner of intangibles will solely be entitled to retain all returns derived from the exploitation of such intangibles if it:

- performs and controls all of the DEMPE (i.e. development, enhancement, maintenance, protection and exploitation) functions;
- provides all assets, including funding, necessary for the DEMPE functions; and
- assumes all risks related to the DEMPE functions.

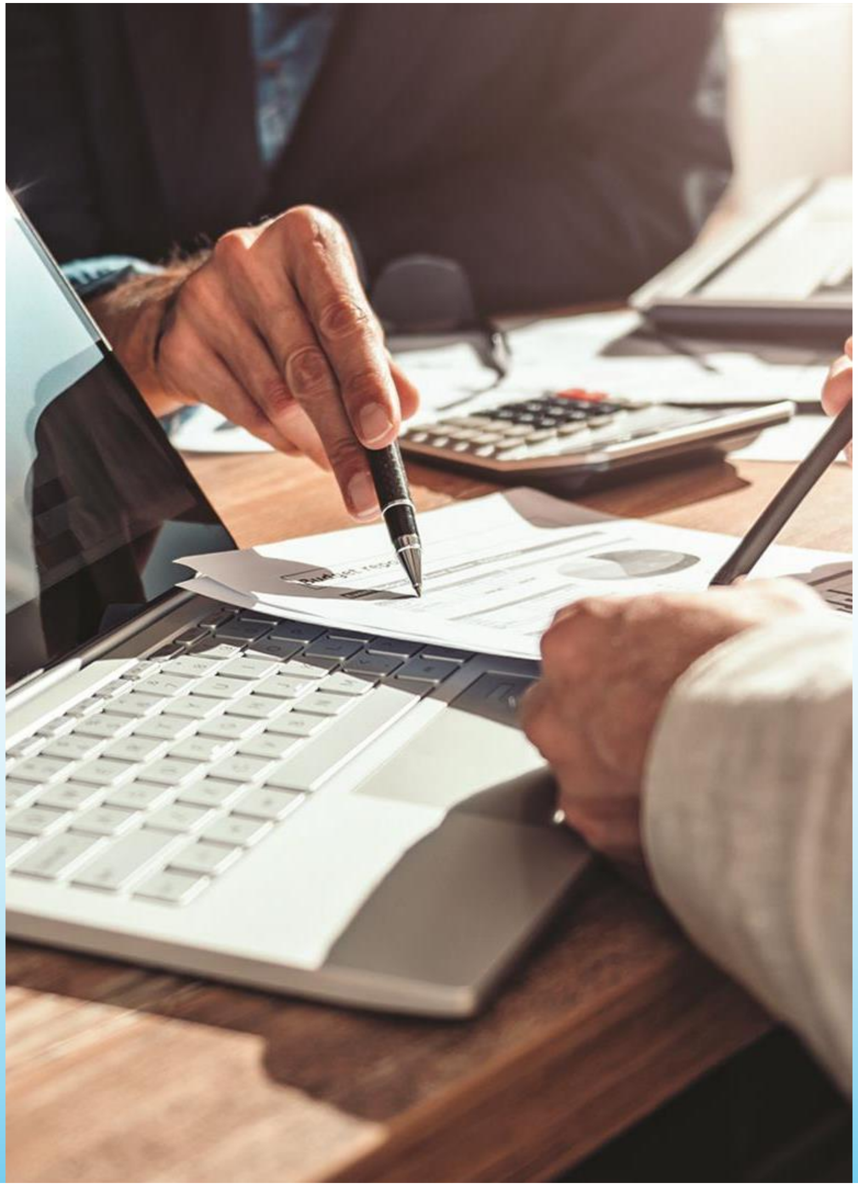
The legal owner can also outsource DEMPE functions to an associated enterprise and still retain or be attributed (a portion of the) return derived from the exploitation of the intangible as long as it:

- is able to exercise control over the risks in connection to those DEMPE functions; and
- has financial capacity to undertake the related risks.

In very short : the presence of people that take decisions is crucial for the allocation of profits.

Selecting the TP method

- The selection of a TP method should be aimed at finding **the most appropriate** TP method for a particular case.
- For this purpose, the selection process should take into account the strengths and weaknesses of the OECD recognized methods, the appropriateness of the method considered in view of the accurate delineated transactions, the availability of reliable information (e.g. uncontrolled comparables) needed to apply the selected method and the degree of comparability between controlled and uncontrolled transactions.
- No one method is suitable in every possible situation, nor is it necessary to prove that a particular method is not suitable under the circumstances. **Nevertheless, the freedom of choice of a method is limited to the most appropriate TP method under the TP Guidelines.**
- This means that where a choice of more than one method is feasible, the taxpayer should not select which of the methods leads to the lowest tax liability, but rather which of the available methods is the most appropriate to achieve an arm’s length outcome.



How to conduct a TP analysis: TP methods

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Traditional Transaction Methods

Transactional Profit Methods

CUP

The CUP method compares the price charged 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.

Comparable uncontrolled price method (CUP)

Transactional net margin method (TNMM)

TNMM

The transactional net margin method examines the **net profit** relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from
a controlled transaction.

TP Methods

RPM

The resale price method compares the gross margin earned on selling or reselling property in a controlled transaction with the gross margin earned on reselling property in an uncontrolled transaction.

Resale price method (RPM)

Transactional profit split method (PSM)

PSM

The PSM identifies the relevant profit to be split from a controlled transaction between the associated enterprises based on the contribution of value with respect to the controlled transaction.

Cost plus method (CPM)

CPM

The CPM, as well as the resale price method, makes a comparison based on gross margins. The CPM compares the gross margin earned on manufacturing goods or providing services in a controlled transaction with the gross margin earned on similar activities.

TP methods in practice

		TP methods
Revenue	**1.000**	**CUP**
Minus: Cost of Sales	700	
Operating margin / gross profit margin	**300**	
Minus: direct cost	100	
Gross profit	**200**	**RPM/CPM**
Minus: indirect costs	50	
Minus: depreciation costs	50	
EBIT	**100**	**TNMM / PSM**
Minus: interest	20	
Net profit	**80**	**PSM**

Methods used in practice

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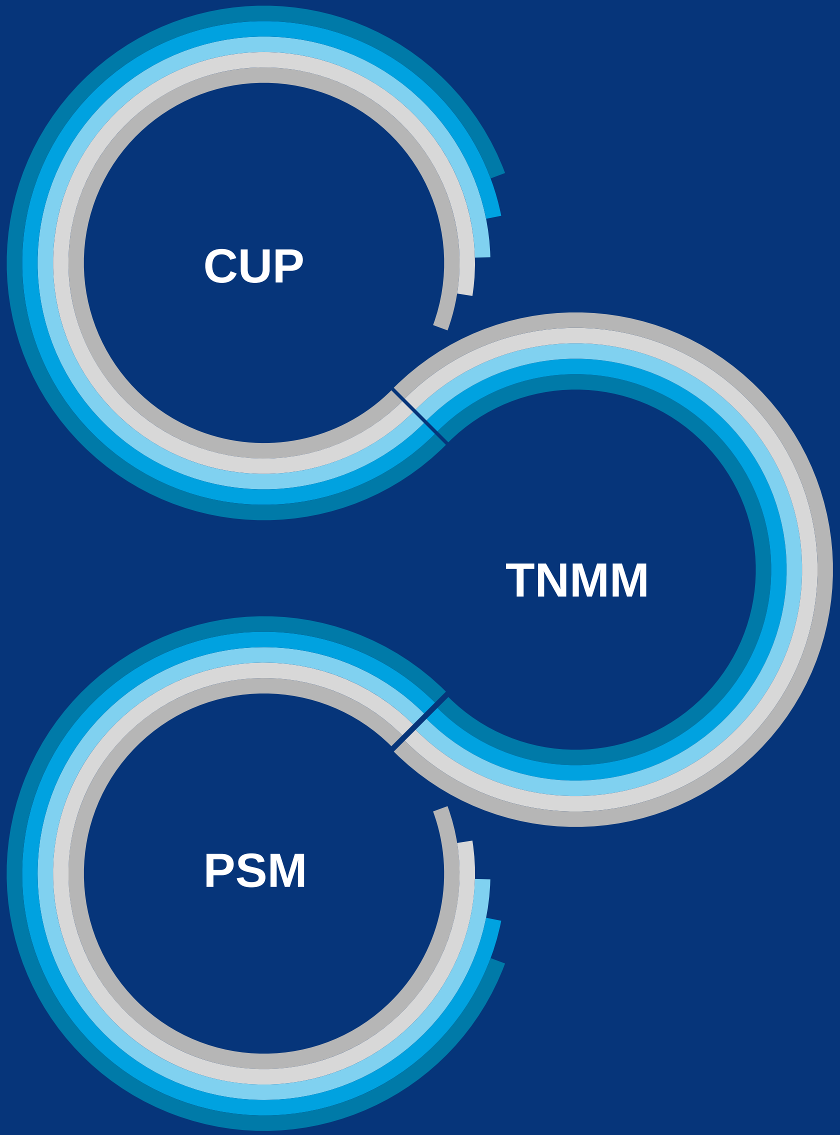

The most common methods used in practice are the CUP method, the TNMM and the PSM.

The practical application of the RPM and the CPM pose difficulties as differential accounting policies followed by enterprises make application of the methods difficult. For example, some enterprises include exchange loss or gain in purchase / sale whilst other enterprises show it as part of indirect expenses.

Public databases usually do not show gross margin data of comparable companies, which makes adjustments based on the different accounting policies challenging.

Overview method used in practice

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CUP

- Establishes a transfer price in a controlled environment by comparing the terms and conditions to those of third-party transactions.
- Reasonably accurate adjustments can be made to eliminate the material effect of relevant differences.
- Internal CUP: transaction between taxpayer and independent enterprise.
- External CUP: transactions between two independent enterprises.
- When CUP method and another method can (equally reliably) be applied, CUP method is generally preferred.
- Applied on homogenous products and/or financial services (with adjustments)

TNMM

- Examines the net profit margin relative to an appropriate base.
- Comparable transactions only need to be broadly similar. Significant product diversity and some functional diversity between transactions are acceptable.
- Applied through the NPI. Most commonly used NPI are ‘sales’, ‘costs’ and ‘assets.
- Applied on limited risk party. Residual profit to entrepreneur.
- Most applied method in practice based on the availability of data in commercial database with key financial figures.
- Applied on low-risk routine manufacturing / services and sales or distribution transactions.

PSM

- Splits profit from a controlled transaction.
- Residual profit: identification routine profit, allocate residual profit based on contribution.
- Applied on unique valuable contributions (no reliable comparable information available).
- Applied on highly integrated operations, separate evaluation not appropriate.
- Applied on transactions with shared assumption of economically significant risks, separate assumption of closely related risks.
- Contribution analysis: split profit based on functions and risks.

Example case

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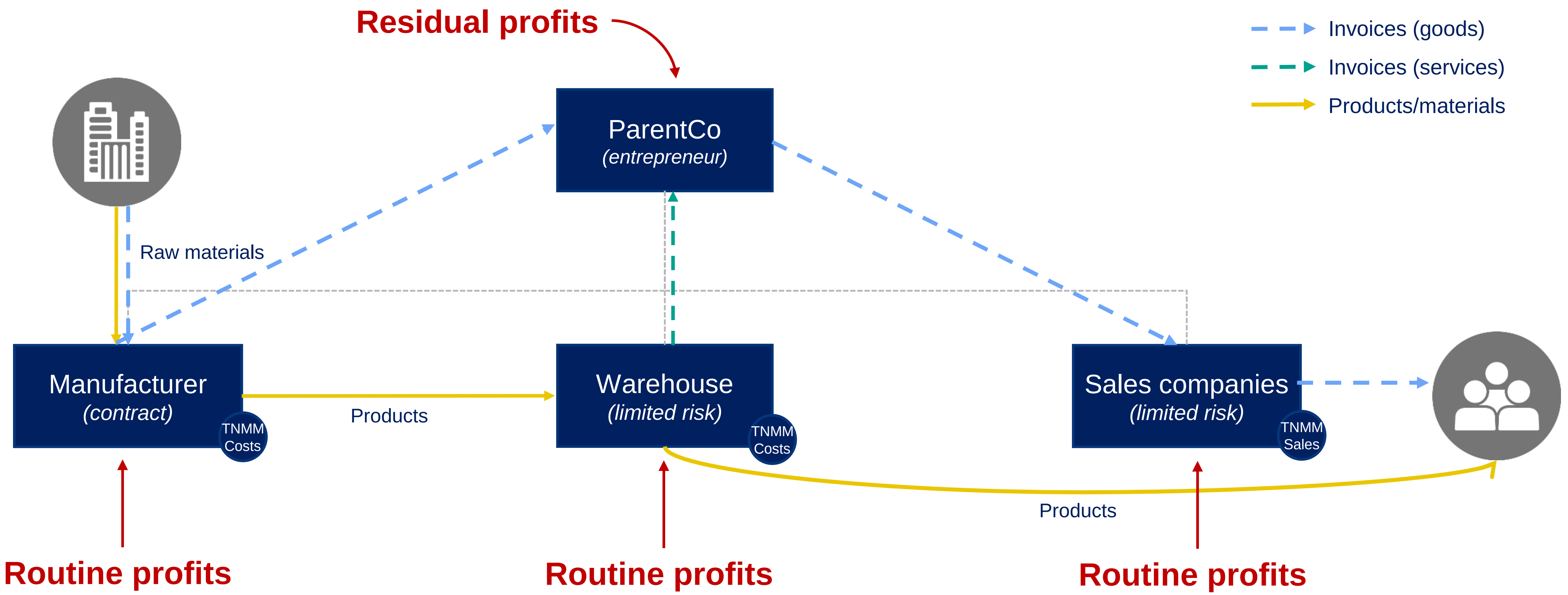

Benchmark analysis

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Benchmark analysis starts with the choice of an appropriate database. Choice of the database depends on the relevant region with respect to the transactions and the type of transaction. Most common used databases are:

- Amadeus / TP Tuned (services, manufacturing)
- Bloomberg / LoanConnector (financial transactions)
- RoyaltyStat (licensing)

Company selection

- **Excludes inaccurate companies** (related entities, non-performing)
- Include **companies based on comparability** factors such as:
  - Status;
  - Region;
  - Shareholder/subsidiary characteristics;
  - Independency status;
  - Year of incorporation;
  - Operating revenue/turnover; and operating profit
  - Type of accounts / Latest year of accounts; and/or
  - Nace codes.

Quantitative screening

- Applying certain **financial ratio screens** to improve the comparability.
- The rejection of **companies that fail to report financials** over a certain time period.
- With respect to limited risk entities, the rejection of companies that **did not report a profit** over a certain period of time.
- In some cases, the rejection of companies **with profit levels that do not fit the functional profile** of the company and controlled transaction under review

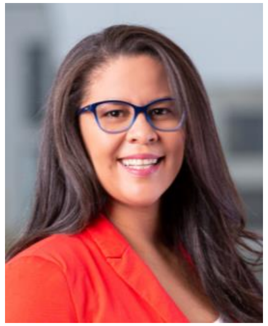
Qualitative screening

- This screening step is **time consuming and involves scrutinizing the remaining companies** by analyzing their business descriptions and other readily available information.
- The companies are **manually reviewed** based on their trade descriptions, website, business brochures and other available information

Statistical analysis

- In theory: where the range comprises results of relatively equal and high reliability, it could be argued **that any point in the range satisfies the arm's length principle.**
- In practice: use of the **interquartile range** excludes comparability defects that cannot be identified and/or quantified and are therefore not adjusted. **Median is applied in order to minimize risk of unknown error in remaining comparability defects.**
- Range needs to include a **sizeable number of observations.**

Have a question? Want to learn more? Get in touch!



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