Day 1, Session 1

Introduction to Transfer Pricing

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Dr. Raffaele Petruzzi, LL.M.

Managing Director, WU Transfer Pricing Center
CEO, PETRUZZI Advisory

Institute for Austrian and International Tax Law Vienna
WU Transfer Pricing Center

PETRUZZI Advisory

Agenda

I. What is transfer pricing?
II. The importance of transfer pricing
III. Different approaches to transfer pricing
IV. The arm's length principle
V. The legal framework to the arm's length principle
VI. The application of the arm's length principle

Annexes

Section I

What is “Transfer Pricing”?

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What is Transfer Pricing?

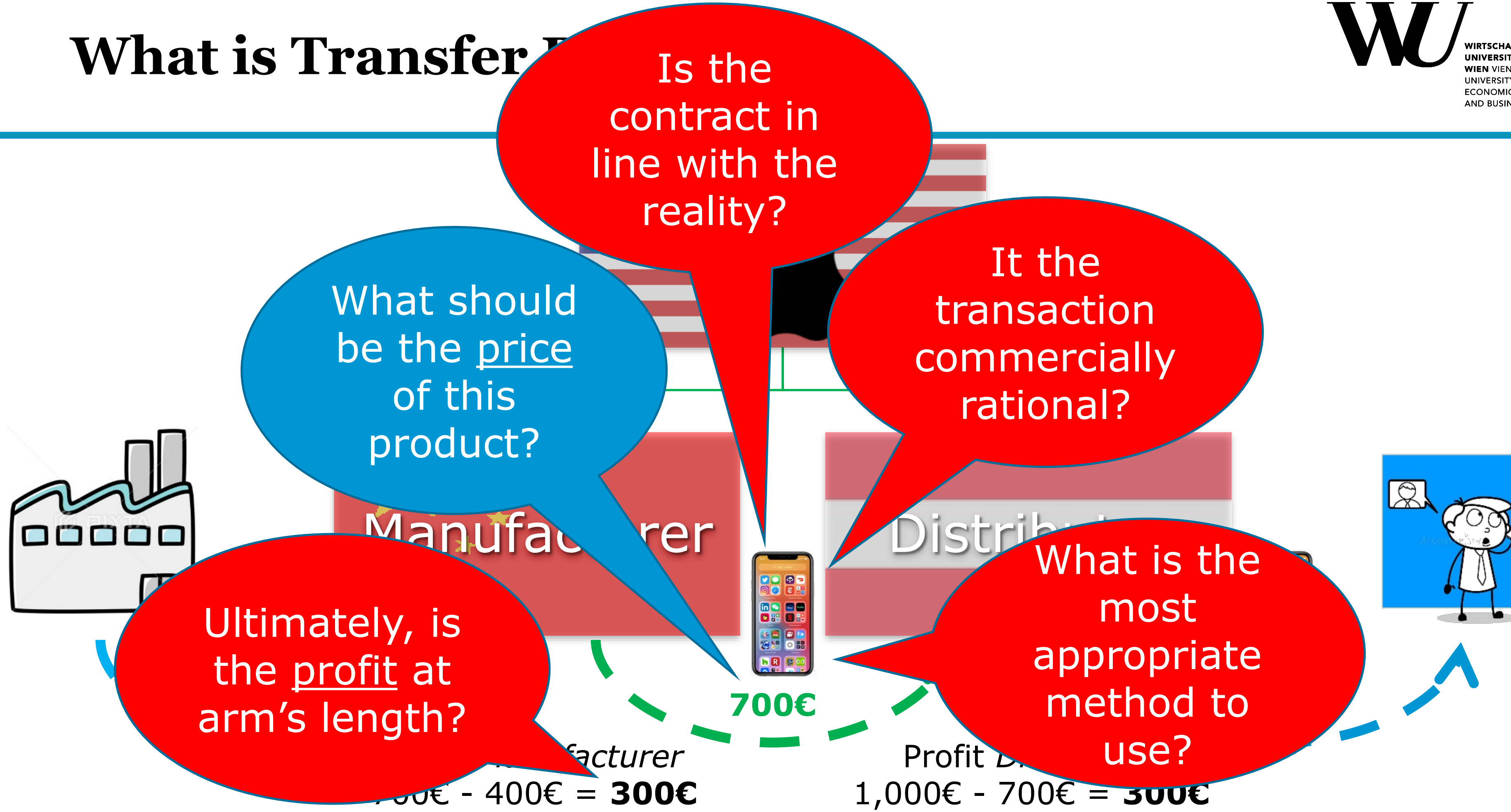
Transfer pricing

Price charged by individual entities for goods or services supplied to one another in multi-department, multi-office, or multinational firms.

Transfer pricing legislation

Particular skill sets in tax that determine the income allocation for tax and other purposes between the respective entities of multinational corporate group.

What is Transfer



Profit *Group*: 300€ + 300€ = **600€**

Section II

The Importance of Transfer Pricing

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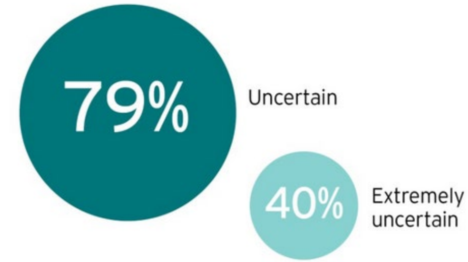
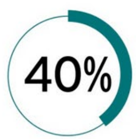
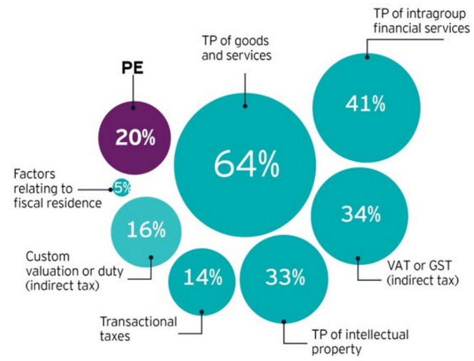
Some Statistics



Among survey respondents, 8 out of 10 (79%) executives describe **today's international tax environment** as "**uncertain**," **and** 40% as "**extremely uncertain**."



Forty percent say that **challenges to transfer pricing** (TP) over the past three years **have led to double taxation**.



BEPS and Transfer Pricing

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Coherence

- Hybrid Mismatch Arrangements (2)
- Interest Deductions (4)
- CFC Rules (3)
- Harmful Tax Practices (5)

Substance

- Preventing Tax Treaty Abuse (6)
- Avoidance of PE Status (7)
- TP Aspects of Intangibles (8)
- TP/Risk and Capital (9)
- TP/High Risk Transactions (10)

Transparency

- Methodologies and Data Analysis (11)
- Disclosure Rules (12)
- TP Documentation (13)
- Dispute Resolution (14)

Digital Economy (1)

Multilateral Instrument (15)

Linked to TP

Is Transfer Pricing "only" a Tax Problem?

- 2012: Starbucks, Amazon and Google accused to be "immoral" by UK
  https://www.youtube.com/watch?v=3TeZlt3dRig

- 2013: BEPS project
  http://www.oecd.org/ctp/beps.htm

- 2014: LuxLeaks
  http://www.parliamentlive.tv/Event/Index/121850ef-001a-44af-9037-582f616ede41

"Margaret Hodge, who chairs the parliamentary committee, told the BBC that she thought **it was right for customers to boycott** the three companies".

Section III

Different Approaches to Transfer Pricing

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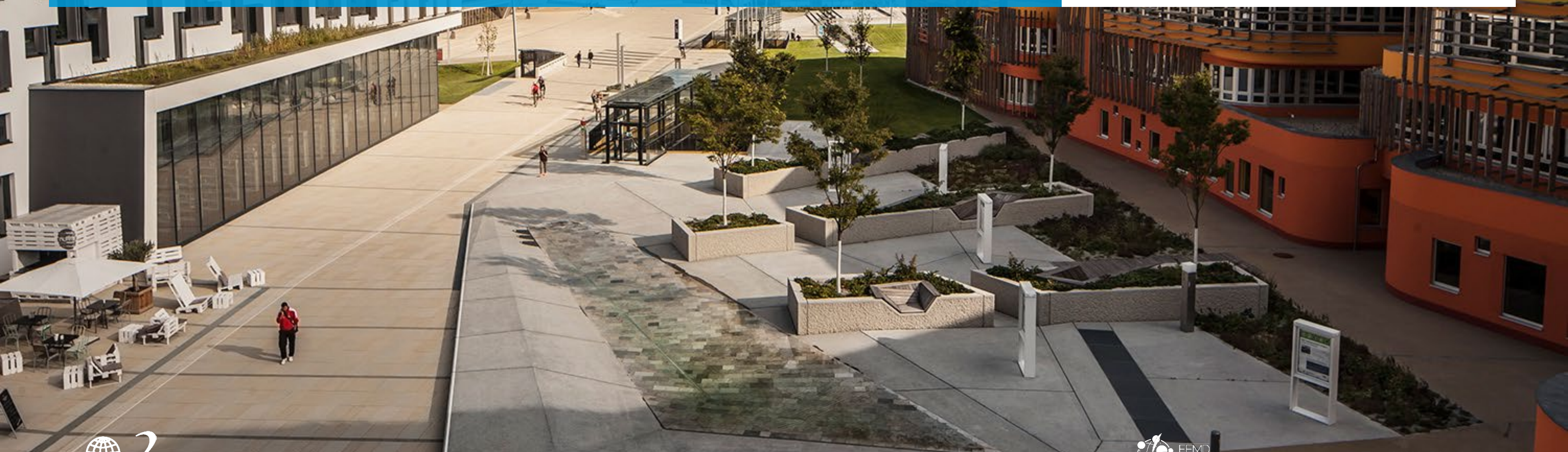
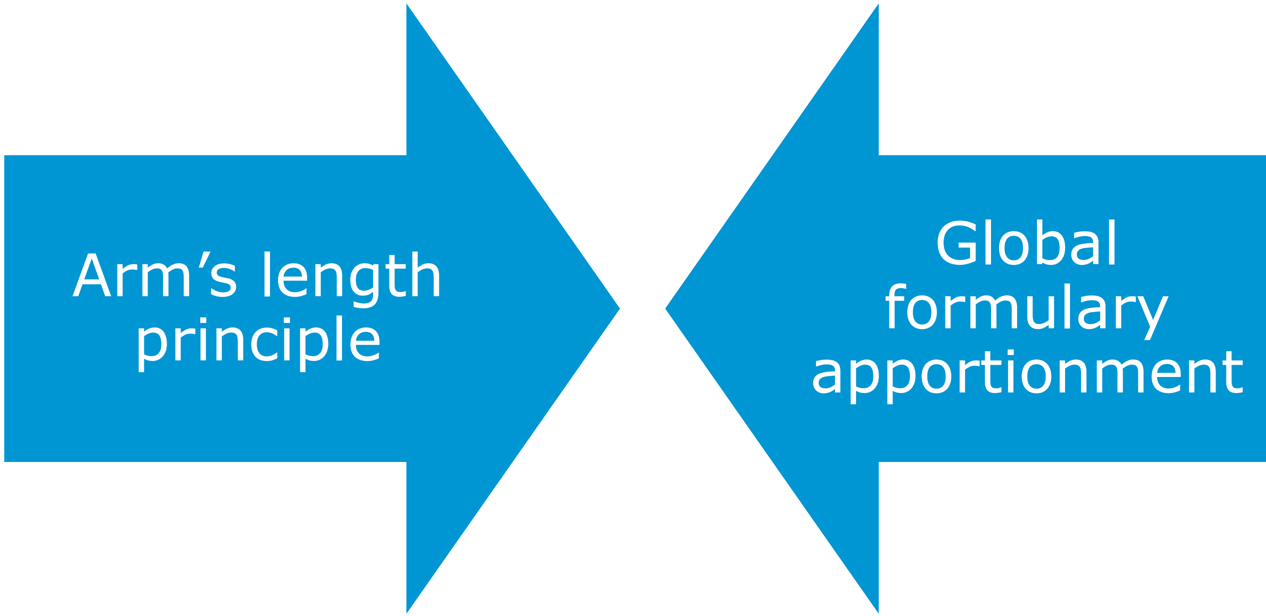
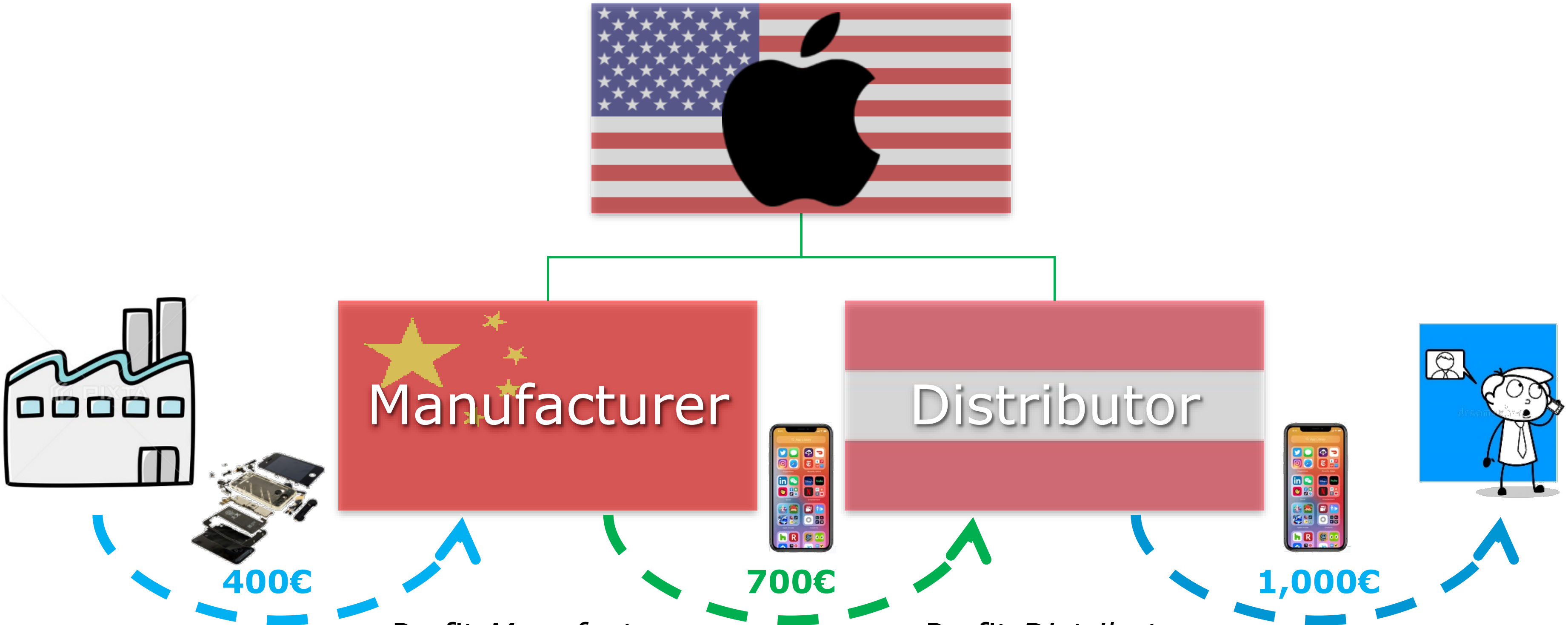


Approaches to Solve Transfer Pricing Issues on an International Level



Global Formulary Apportionment

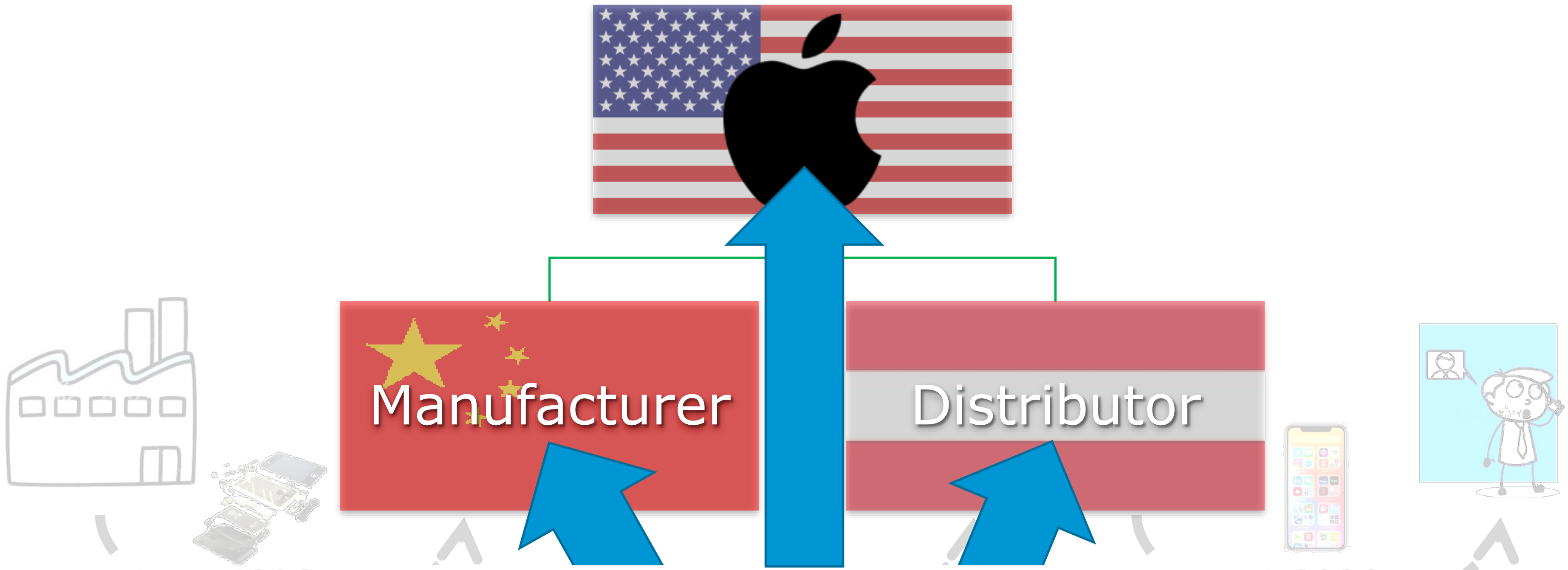


Profit *Manufacturer*
700€ - 400€ = **300€**

Profit *Distributor*
1,000€ - 700€ = **300€**

Profit *Group*: 300€ + 300€ = **600€**

Global Formulary Apportionment



Allocation based on a **globally agreed formula**
(e.g. *revenues*, *assets*, *human capital*)

Profit *Group*: 300€ + 300€ = **600€**

Global Formulary Apportionment

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Advantages

- (Perceived) administrative convenience and certainty to taxpayers
- (Perceived) closer representation of the economic reality
- (Perceived) reduction of compliance costs for taxpayers

Disadvantages

- Difficulties in reaching a general agreement on the profits and formula to be used
- Inflexibility in accounting for specific characteristics of single entities
- Difficulties in granting an efficient implementation
- High political and administrative complexity
- Subjectivity in defining the global formula
- Negative distortions deriving from exchange rate movements
- High compliance costs and data requirements
- Substantive valuation issues related to all relevant factors to allocate taxable base within the MNE group (especially in phase-in)
- Questions about the relevance of imposing withholding taxes on cross-border payments
- Difficulties in administrating the relationships between group members included in the formulary apportionment and group members excluded from the formulary apportionment

Section IV

The Arm's Length Principle

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Art. 9(1) OECD Model Convention

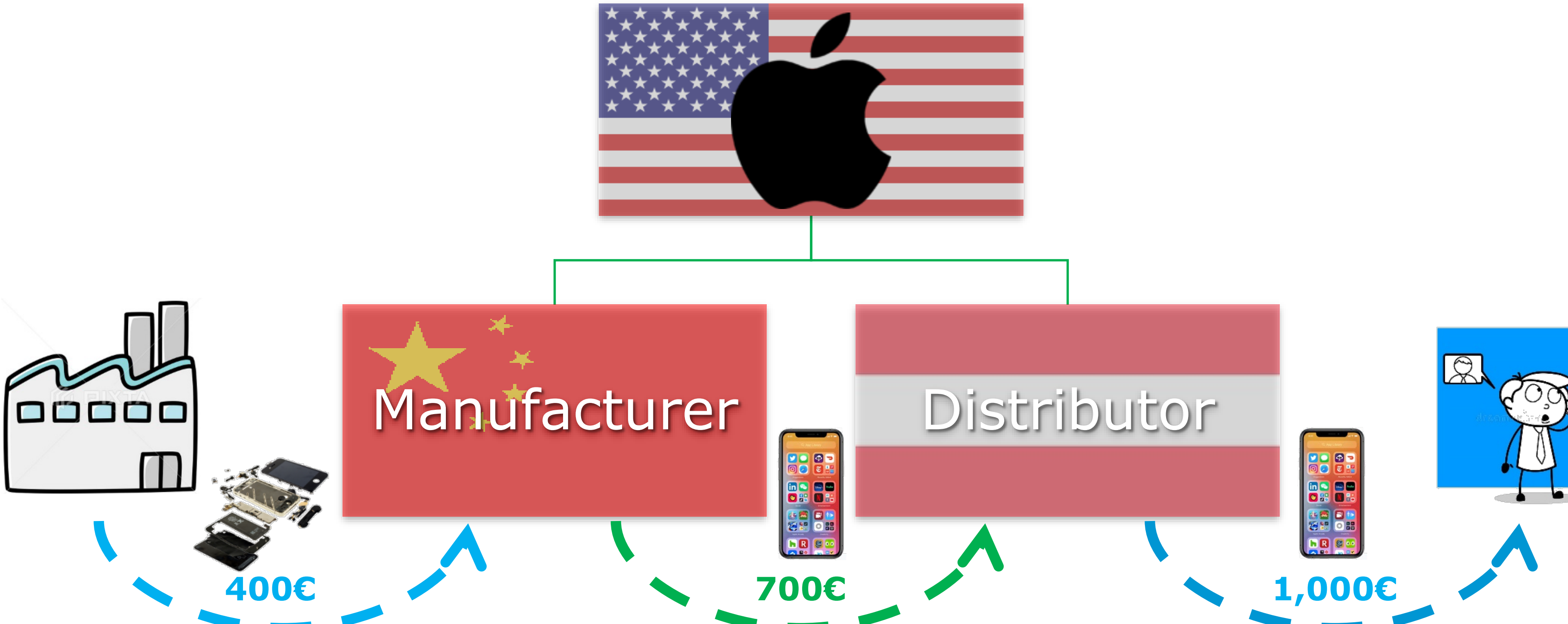
Where

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case **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.

Art. 9(1) OECD Model Convention

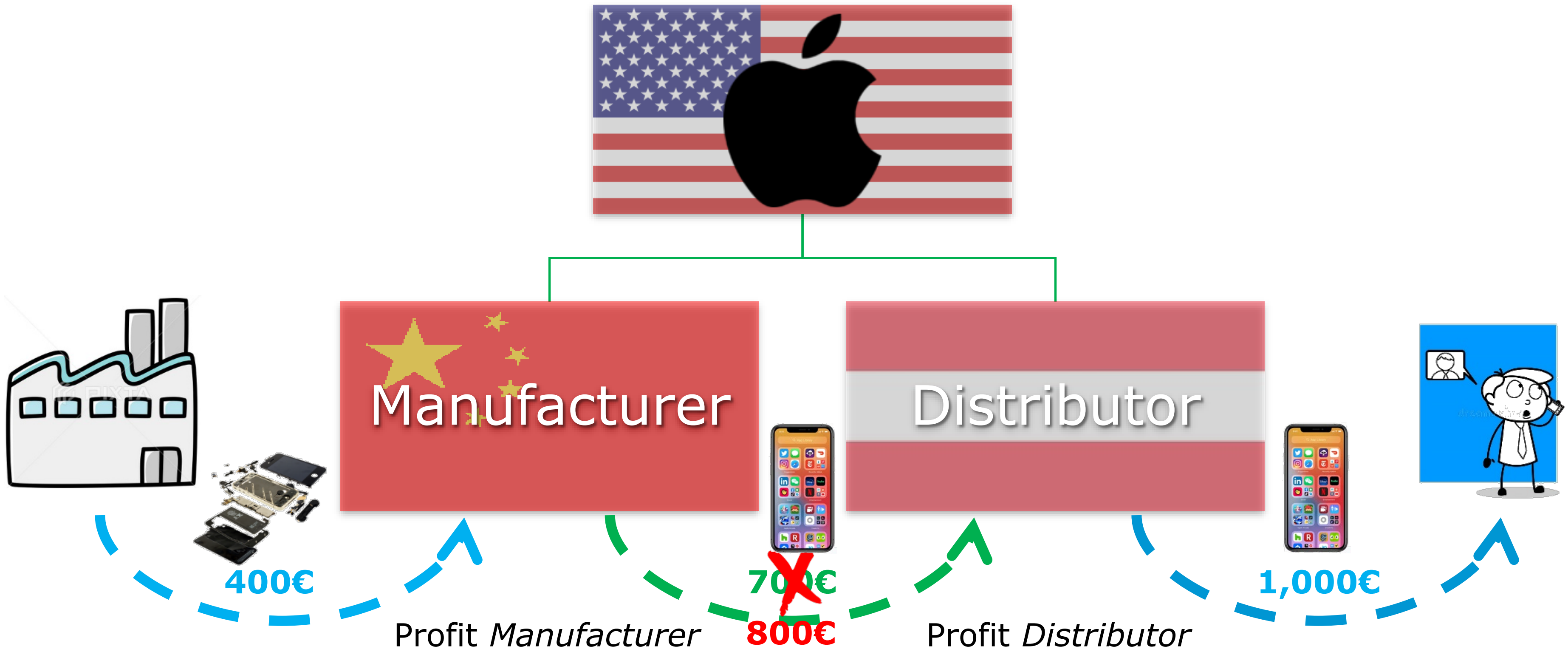


Profit *Manufacturer*
700€ - 400€ = **300€**

Profit *Distributor*
1,000€ - 700€ = **300€**

Profit *Group*: 300€ + 300€ = **600€**

Primary Adjustments
Art. 9(1) OECD Model Convention



Profit *Manufacturer*
800€ - 400€ = **400€**

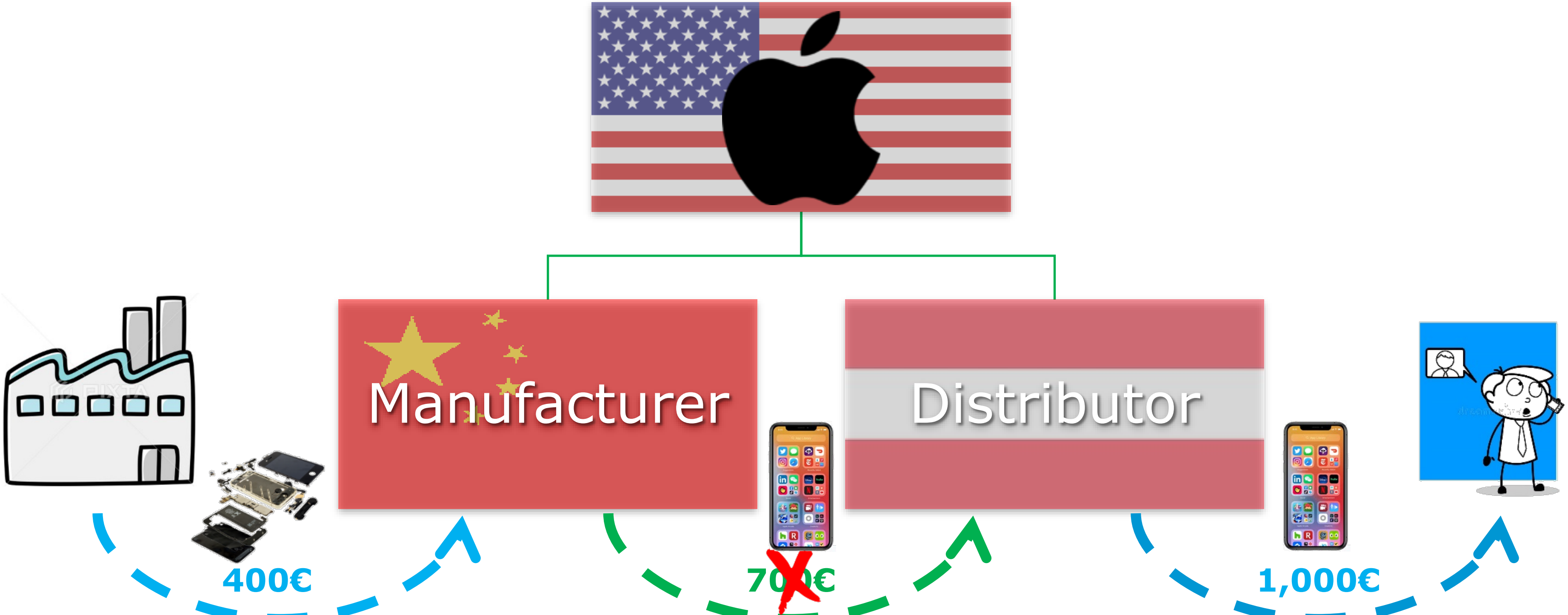
Profit *Distributor*
1,000€ - 700€ = **300€**

Profit *Group*: 400€ + 300€ = **700€**

Corresponding Adjustments (Art. 9(2) OECD Model Convention)

Where a Contracting State includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State **shall make an appropriate adjustment** to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

Corresponding adjustments (Art. 9(2) OECD Model Convention)



800€

Profit *Manufacturer*
800€ - 400€ = **400€**

Profit *Distributor*
1,000€ - 800€ = **200€**

Profit *Group*: 400€ + 200€ = **600€**

The Arm’s Length Principle

Advantages

- Equal treatment of related and unrelated transactions
- Allowance commercial flexibility for specific business circumstances
- Prevention of phenomena of tax avoidance and/or aggressive tax planning
- Avoidance of double taxation and of less-than-single taxation
- Fair and balanced allocation of taxing powers between different states
- Stability and certainty of law
- Overcome issues related to cross-border transactions
  - Compatibility with tax treaties
  - Compatibility with EU law
- Enforceability
- Allowance of a coordinated approach
- Avoidance of conflicts between different kinds of rules

Disadvantages

- Difficulties in its implementation
  - Separate entity approach
  - Comparability analysis
- Administrative burden
- Lack of information

Section V

The Legal Framework to the Arm's Length Principle

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Elements of the Arm's Length Principle

- **Subjective scope**: Related enterprises
- **Objective scope**: Profits
- **3 Pillars:**
  - Separate entity approach (vs. market approach)
  - Contractual arrangements (vs. substance of the transaction)
  - Comparability analysis (vs. use of proxies)
- **Basic understanding**: In general, the more functions/assets/risks, the more profit or loss potential

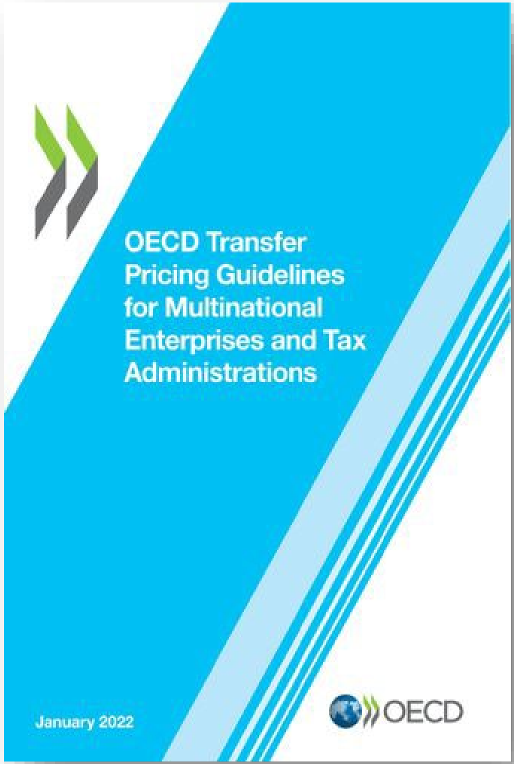
The Legal Basis for Transfer Pricing Adjustments

- **OECD/UN Model Tax Conventions and Tax treaties**
  - Art. 9 limits the amount of the adjustments (but does not create taxing rights)

- **Domestic law**
  - Is the legal basis for the adjustments
  - Applicable rules
    - hidden profit distribution ("constructive dividend")
    - hidden contribution ("informal capital")
    - sometimes specific TP rules exist (e.g. § 1 ASTG in Germany, US IRC Section 482)
  - Potential differences compared to Art. 9 and OECD TPG

The OECD Transfer Pricing Guidelines

- Provide guidance for applying the arm's length principle
- Based on the 1979 Report
- First issued in 1995 and adopted by the OECD Council
- Last update: January 2022 (approved on 7 January 2022)
- http://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm



Importance of OECD Transfer Pricing Guidelines

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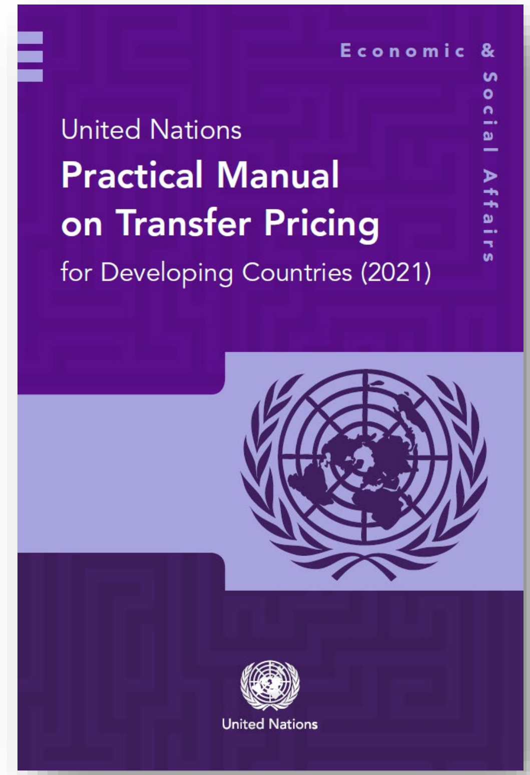
- Interpretation of Art. 9 MC
  - Approved by Committee on Fiscal Affairs
  - Recommended by OECD Council
- Legally not binding – OECD TPG have "soft law" character ("recommendations")
- Relevance: Vienna Convention on the Law of Treaties (Art. 31-33)
- Give guidance to taxpayers & tax administration on how to determine the arm's length price
- Significant practical importance
- Use in court cases? Court can make reference but must apply local law
- Relevance for non-OECD Countries?

The UN Transfer Pricing Manual

- Provide guidance for applying the arm's length principle
- Issued in 2013
- Revised in 2017 and 2021
- https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2021-04/TP_2021_final_web%20%281%29.pdf



Section VI

The Application of the Arm’s Length Principle

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The Process to Apply the Arm's Length Principle

1. **Accurate delineation** of the actual transaction

2. **Recognition** of the accurately delineated transaction

3. **Selection** of the most appropriate **transfer pricing method**

4. **Application** of the most appropriate **transfer pricing method**

See PETRUZZI, COTTANI, LANG, Fundamentals of Transfer Pricing: General Topics and Specific Transactions, Chapter 1

Section VI(a)

1. Accurate Delineation of the Actual Transaction

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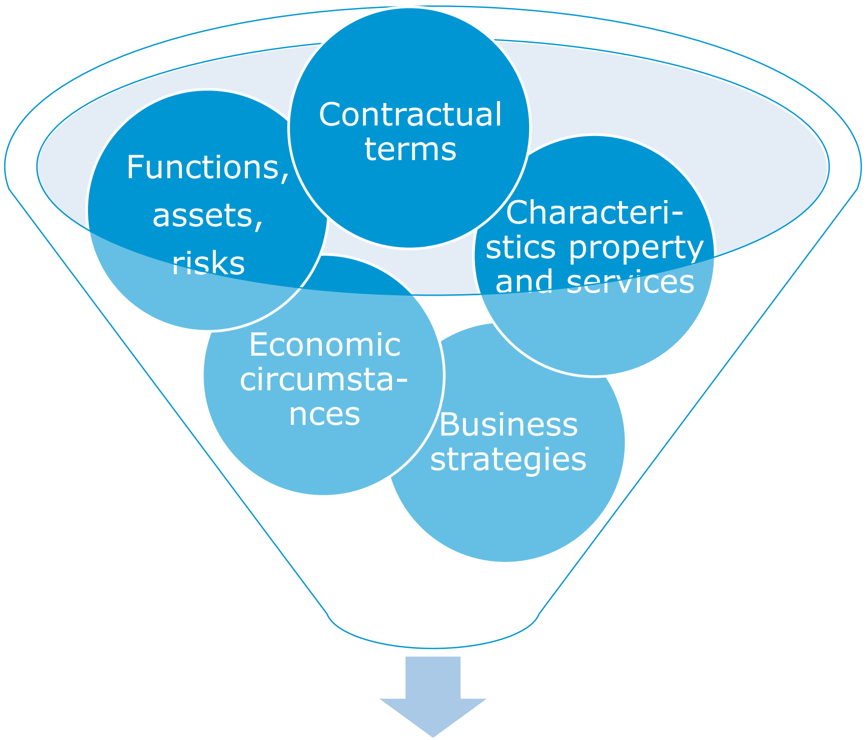
Identification of the Commercial or Financial Relations



Identification of the **commercial or financial relations**

(by means of the above **economically relevant characteristics** or **comparability factors**)

Section VI(b)

2. Recognition of the Accurately Delineated Transaction

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Recognition of the Accurately Delineated Transaction

- The transaction may be disregarded (and if appropriate, replaced by an alternative transaction) where, exceptionally:
  - The arrangements viewed in their totality differ from those which would have been adopted by independent enterprises behaving in a **commercially rational manner** in comparable circumstances,
  - thereby **preventing determination of a mutually acceptable price**, taking into account their **options realistically available**.

- A relevant pointer: if the group would be worse off but for the tax benefit

Section VI(c)

3-4. Selection and Application of the Most Appropriate TP Method

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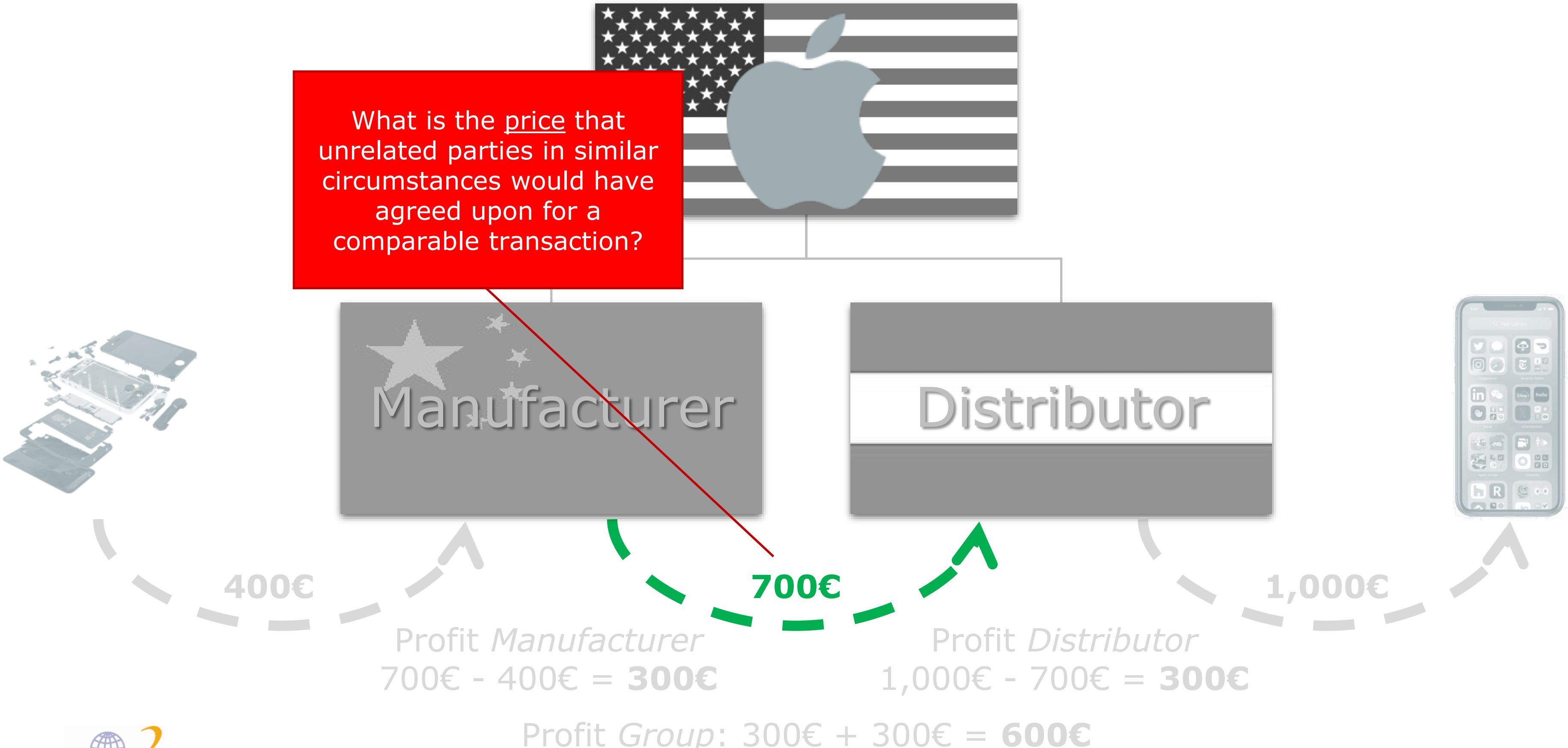
Methods to Determine the Arm's Length Price

- **Traditional Transaction Methods**
  - Comparable Uncontrolled Price (CUP)
  - Resale Price Method (RPM)
  - Cost Plus Method (CPM)

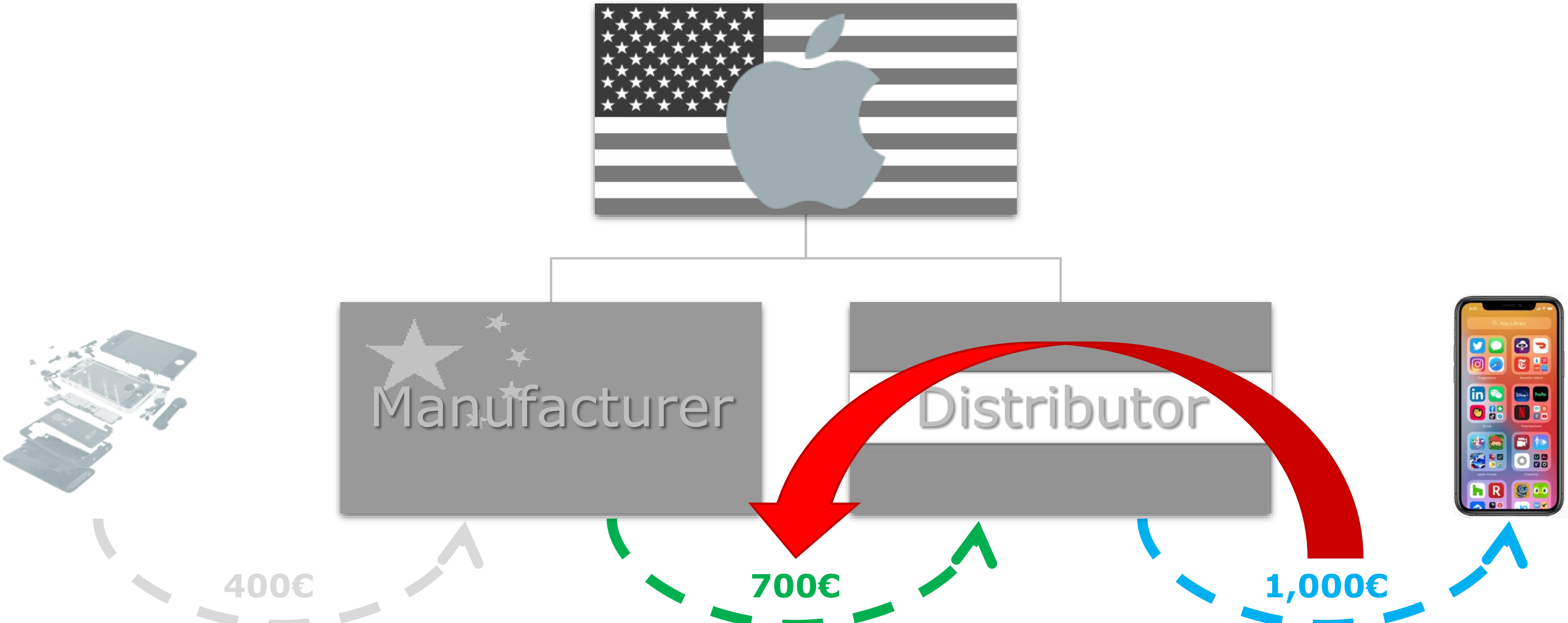
- **Transactional Profit Methods**
  - Transactional Net Margin Method (TNMM)
  - Transactional Profit Split Method (TPSM)

Most appropriate method!

Comparable Uncontrolled Price (CUP)



Resale Price Method (RPM)



Profit *Manufacturer*
700€ - 400€ = **300€**

Profit *Distributor*
1,000€ - 700€ = **300€**

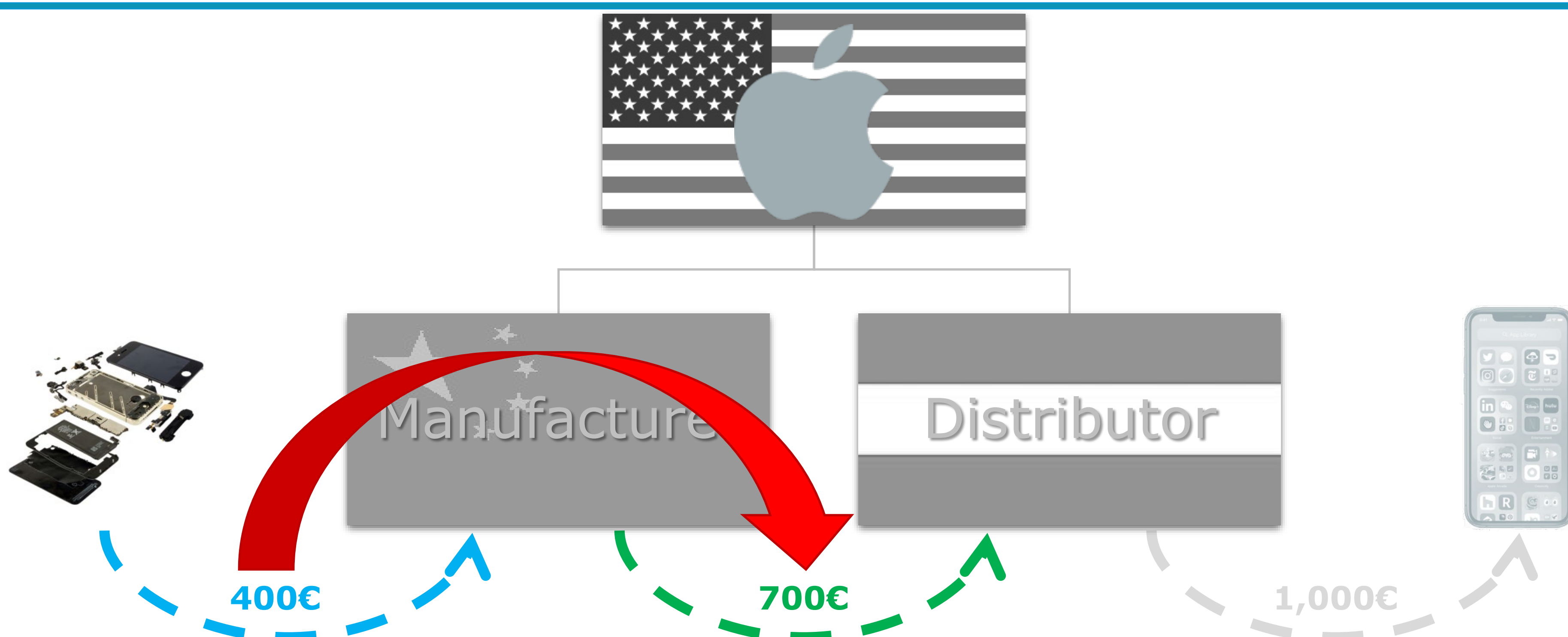
Profit *Group*: 300€ + 300€ = **600€**

Resale Price Method (RPM)

What is the gross profit margin that unrelated parties in similar circumstances would have agreed upon for a comparable transaction?

P&L Distributor	EUR	Gross Profit Margin
Operating revenues	1,000	
- Cost of Goods Sold	(700)	
Gross profit/loss (EBITDA)	**300**	**30%**
Other operating expenses ▪ Selling, general and administrative expenses ▪ Depreciation ▪ Amortization ▪ Impairment losses	(200)	
Operating profit/loss (EBIT)	**100**	
± Interest income/expenses	(20)	
± Other income/expenses	(30)	
Net profit/loss (before taxes)	**50**	
Taxes (20%)	(10)	
Net profit/loss (after taxes)	**40**	

Cost Plus Method (CPM)



Profit *Manufacturer*
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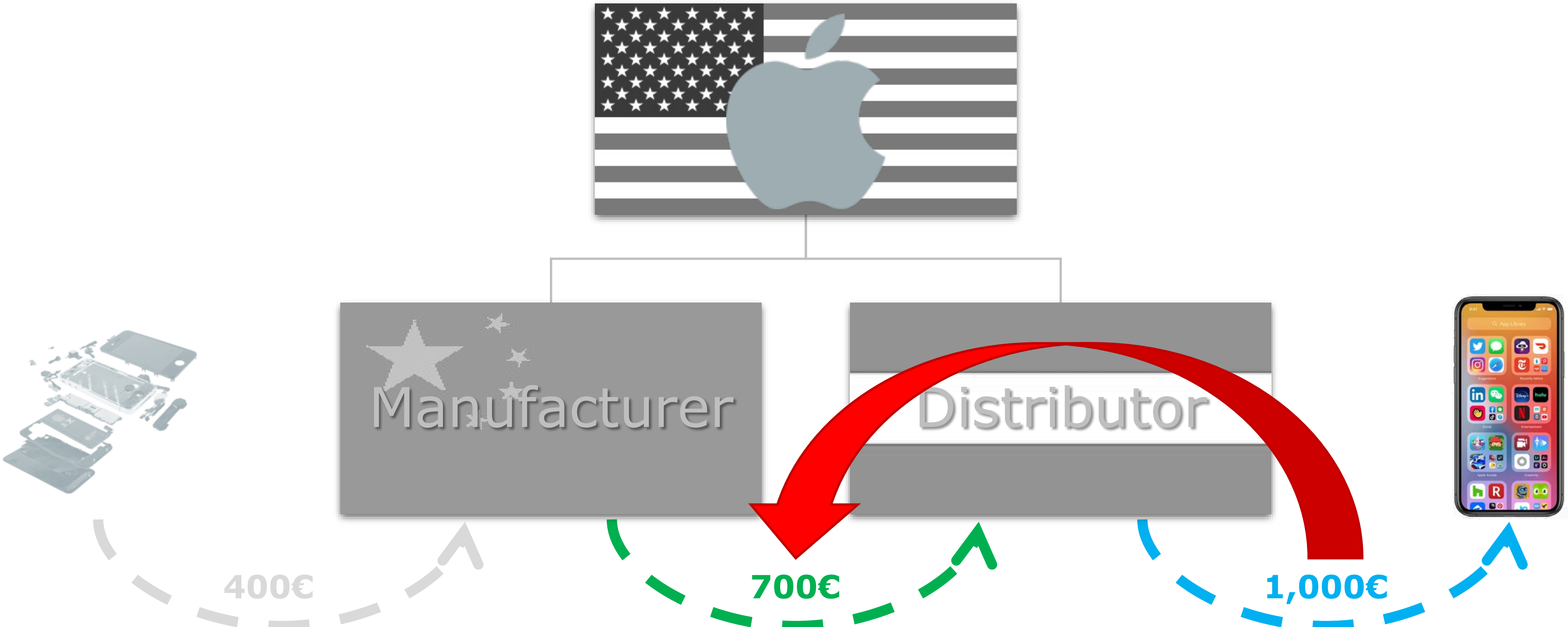
Profit *Group*: 300€ + 300€ = **600€**

Cost Plus Method (CPM)

What is the gross mark-up that unrelated parties in similar circumstances would have agreed upon for a comparable transaction?

P&L Manufacturer	EUR	Gross Mark-up
Operating revenues	700	
- Cost of Goods Sold	(400)	
Gross profit/loss (EBITDA)	**300**	**75%**
Other operating expenses ▪ Selling, general and administrative expenses ▪ Depreciation ▪ Amortization ▪ Impairment losses	(200)	
Operating profit/loss (EBIT)	**100**	
± Interest income/expenses	(20)	
± Other income/expenses	(30)	
Net profit/loss (before taxes)	**50**	
Taxes (20%)	(10)	
Net profit/loss (after taxes)	**40**	

Transactional Net Margin Method (TNMM) (revenue based)



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Profit *Distributor*
1,000€ - 700€ = **300€**

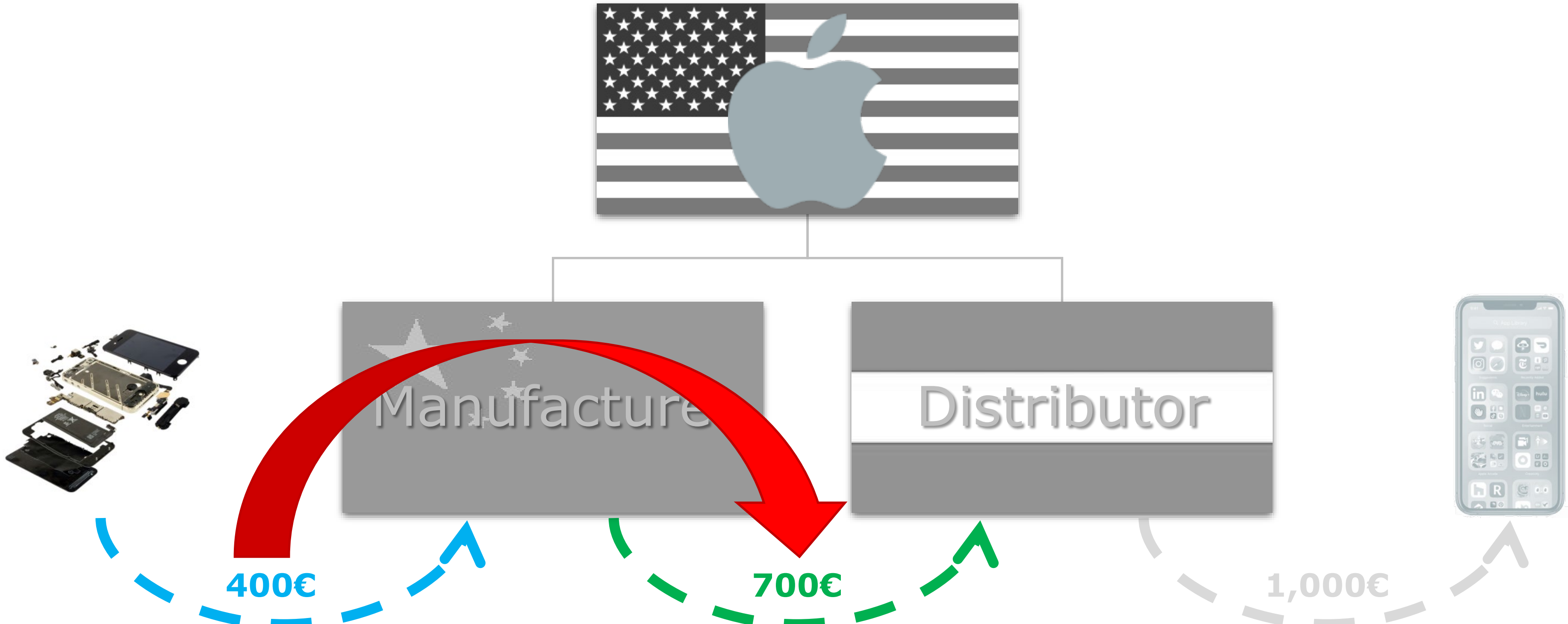
Profit *Group*: 300€ + 300€ = **600€**

Transactional Net Margin Method (TNMM) (revenue based)

What is the net profit margin (ROS) that unrelated parties in similar circumstances would have agreed upon for a comparable transaction?

P&L Distributor	EUR	Net Profit Margin
Operating revenues	1,000	
- Cost of Goods Sold	(700)	
Gross profit/loss (EBITDA)	**300**	
Other operating expenses ▪ Selling, general and administrative expenses ▪ Depreciation ▪ Amortization ▪ Impairment losses	(200)	
Operating profit/loss (EBIT)	**100**	**10%**
± Interest income/expenses	(20)	
± Other income/expenses	(30)	
Net profit/loss (before taxes)	**50**	
Taxes (20%)	(10)	
Net profit/loss (after taxes)	**40**	

Transactional Net Margin Method (TNMM) (cost based)



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Profit *Distributor*
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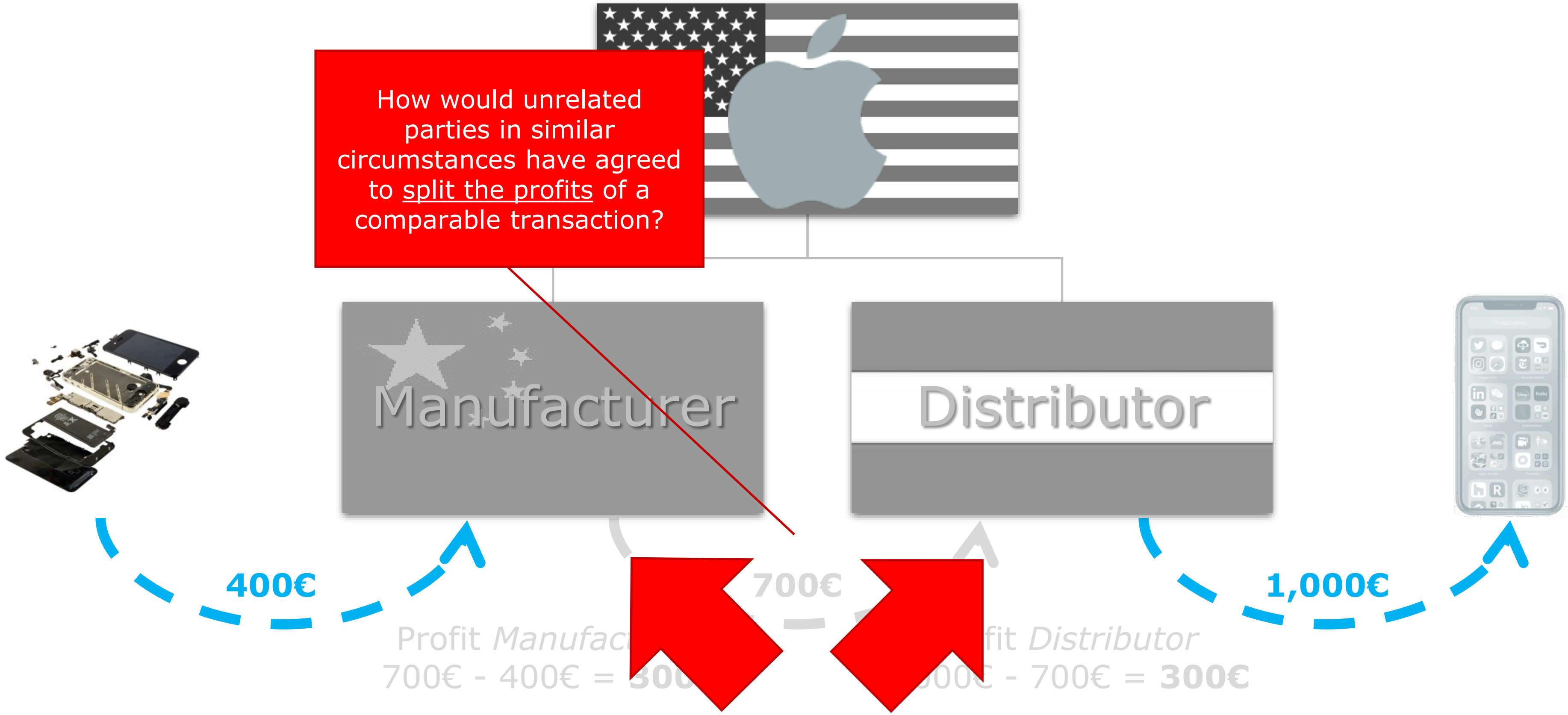
Profit *Group*: 300€ + 300€ = **600€**

Transactional Net Margin Method (TNMM) (cost based)

What is the net mark-up (ROTC) that unrelated parties in similar circumstances would have agreed upon for a comparable transaction?

P&L Manufacturer	EUR	Gross Mark-up
Operating revenues	700	
- Cost of Goods Sold	(400)	
Gross profit/loss (EBITDA)	**300**	
Other operating expenses ▪ Selling, general and administrative expenses ▪ Depreciation ▪ Amortization ▪ Impairment losses	(200)	
Operating profit/loss (EBIT)	**100**	**17%**
± Interest income/expenses	(20)	
± Other income/expenses	(30)	
Net profit/loss (before taxes)	**50**	
Taxes (20%)	(10)	
Net profit/loss (after taxes)	**40**	

Transactional Profit Split Method (TPSM)



Profit *Group*: 300€ + 300€ = **600€**

Contact Details

VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Dr. **Raffaele Petruzzi**, LL.M.

Managing Director

WU Transfer Pricing Center

Institute for Austrian and International Tax Law

WU (Vienna University of Economics and Business)

T +43-1-313 36-5065

raffaele.petruzzi@wu.ac.at

www.wu.ac.at/taxlaw, www.wu.ac.at/dibt

PETRUZZI & Advisory

Dr. **Raffaele Petruzzi**, LL.M.

CEO

PETRUZZI Advisory

raffaele.petruzzi@petruzziadvisory.com

www.petruzziadvisory.com

Am grünen Prater 10/6 - 1020 Vienna (Austria)

Annex I

Special Focus: Secondary Adjustments

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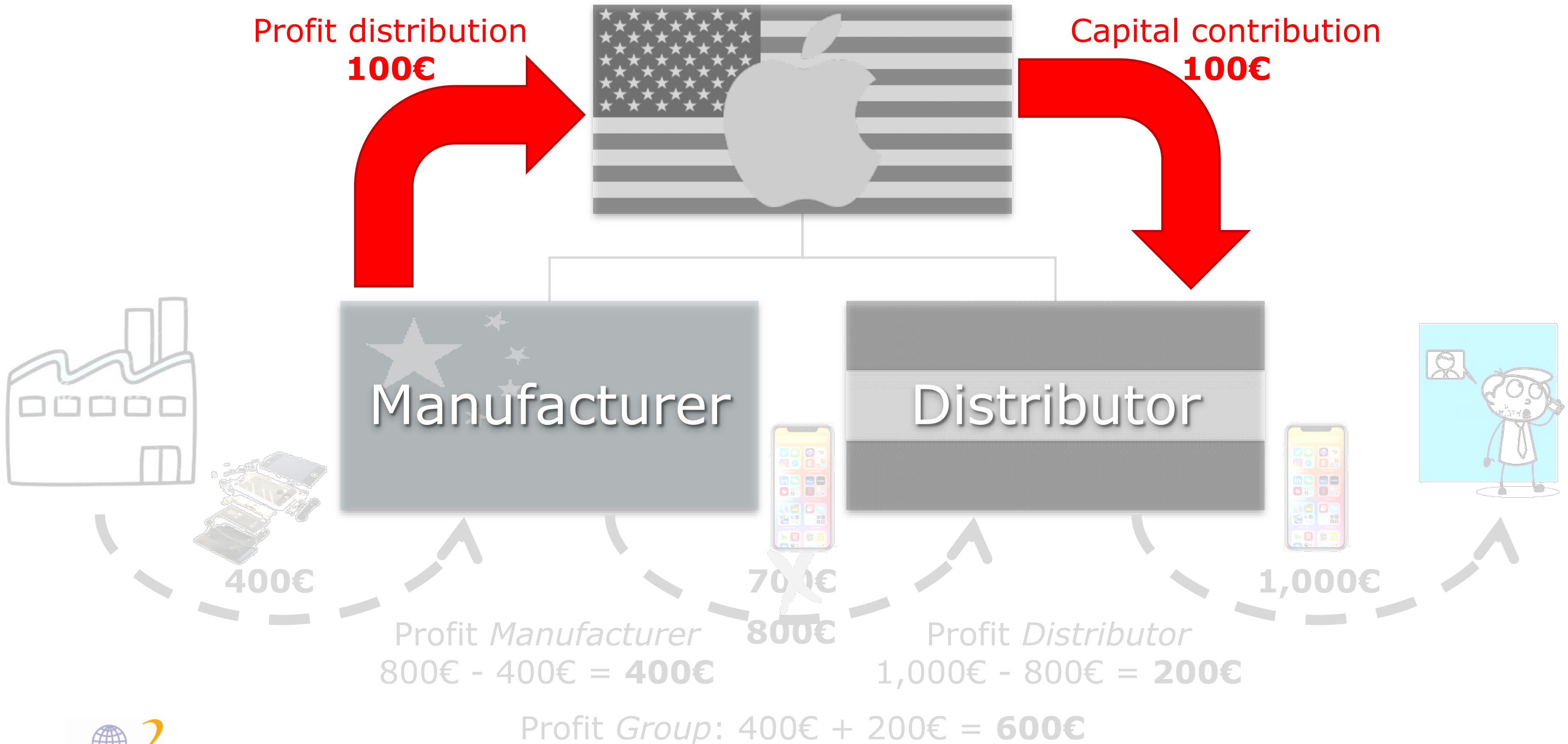
Adjustments

- **Compensating** adjustments
- Adjustments **to the comparable data**
- **Primary** adjustments
- **Corresponding** adjustments
- **Secondary** adjustments

Secondary Adjustments



Secondary Adjustments