Transfer Pricing in Industry Sectors

Ing. David Fresar

1. Transfer pricing methods for intangible assets

The nature of the agreement under which intangible rights are transferred will influence both the level of transfer price charged and the method by which an arm's length transfer price may be established. The next section explains the application of the basic pricing methods to intangible assets and indicates which methods are likely to be usable in this context.

1.1. Comparable uncontrolled price

The CUP method may be used if the owner has transferred or licensed comparable intangible property under comparable circumstances to independent enterprises. This is often referred to as the comparable uncontrolled transactions (CUT) method. For example, the hotel group Excalibur referred to above may charge the third party franchisees a fee of 2% of turnover for the rights to use the specified Excalibur intangible assets (name, booking system and interior design concept). The group may charge its wholly owned hotei subsidiaries a 2% fee for the use of the same intangibles as being an arm's length price. Offers to unrelated parties, genuine bids from competing licensees and even industry standards may also be used as guidance in determining arm's length pricing according to the OECD Guidelines.

The owner of a valuable intangible will often only be prepared to exploit this property through related companies. In these circumstances there is only limited scope for finding closely comparable uncontrolled transactions. Some details of uncontrolled transactions may be identified in the published accounts of other companies operating in the same industry or market sector particularly those in the pharmaceutical industry. However, even when such arm's length arrangements (e.g. licences) can be identified it is usually difficult or impossible to establish the precise terms of these arrangements. If the terms of the uncontrolled transactions cannot be established then they cannot reliably be used as comparable uncontrolled transactions other than in defining a broad range. When such terms are known then adjustments will be required for differences between the terms of the controlled and the uncontrolled transactions in order to use the pricing of the latter to establish an arm's length price of the former.

In practice, it is unusual to find an exact CUP or CUT for a controlled transaction involving the transfer of intangible assets and it is most likely that other methods will have to be applied at least to supplement or endorse the results of a CUT analysis.

1.2. Resale price method

The resale price method may be applicable when the owner of the intangible grants a licence to a related company which, in turn, grants a sub-licence to an unrelated party. This may be the case, for example, when the developer of pre-packaged software grants a licence in a particular territory to a related party distributor which sells the product, including a sub-licence, to end users. To apply the RPM the developer would charge the distributor a product price based on a discount from the selling price to the third party customers. The discount or gross margin would be derived from the range of gross margins achieved by independent distributors trading similar products (including a sub-licence) in the same market.

It may be expected that a distributor will pay a higher transfer price for goods with added intangibles because this should increase the final selling price achieved, or reduce the local marketing costs incurred, or both. The net result of buying a branded product rather than an unbranded product is that cost is moved out of the distributor's general, administrative and selling costs and into the transfer price paid to the associated enterprise. This reduces the gross profit earned but may leave the net profit unaffected.

1.3. Cost plus method

In some instances it is possible to refer to the amount, nature and incidence of costs incurred in developing and maintaining the intangible property as a means of determining an appropriate charge for the transfer of that intangible. MNCs in innovative industries which rely on a 'pipeline' of new products for long-term survival frequently ensure that the inter-company royalties from manufacturing sites outside their home country are sufficient to cover an appropriate share of the ongoing R&D expenditure. Similarly, licence fees for IT systems development originally borne by one group company and subsequently used by a number of other group companies may be charged out based on the original cost.

However, there are real limitations in the use of a cost-based method to value transfers of intangibles. The developer incurs a risk that the R&D may fail. The greater this risk, the less appropriate it will be to take into account the cost of development as a method to value the result of that development. Even where there is little prospect of failure (such as in producing a new mode! of an already proven product), the value of the intangible property in the open market may have little relationship to the costs incurred in its development. Hence, the cost plus method is of limited application in determining an arm's length value for the transfer of intangibles and other methods may have to be considered.

1.4. Transactional net margin method

It is sometimes possible to apply the TNMM (or CPM under the US regulations) to establish an arm's length price for a transfer of intangible property between related parties. For example, this may be the case when the owner of a manufacturing process licenses the process to a related party ('Manufacturing Co.') for use in a particular market. In these circumstances, to apply the TNMM, it will be necessary to identify independent manufacturers with the following characteristics:

- they produce broadly comparable products to those of Manufacturing Co.;
- they sell these products at a similar level in the market and in similar volumes to Manufacturing Co.; and
- they do not own significant unique process intangibles of their own (as evidenced by an absence of expenditure on R&D).

The financial results of such comparable independent companies can be used to establish a range of arm's length operating margins or profits. These margins or profits can be applied, under the TNMM or CPM, together with the forecast costs and sales of Manufacturing Co. to provide guidance on the level of arm's length royalty which Manufacturing Co. should pay to the related company which owns tne rights to the manufacturing process. The following example illustrates the method.

1.5. Use of CPM or TNMM to set royalty rates

Fig. 1.5 − Manufacturing Co. five year forecast:

Sales	100	
Cost of sales	(50)	
Other overheads	(20)	
Pre-royalty operating profit	30	
Calculated royalty	(23)	
Arm's length profit	7	Operating profit margin of third party comparables = 7%

In practice it is often difficult to find closely comparable arrangements involving intangible property such that the TNMM or CPM methods can be applied with certainty. Often it is necessary to make adjustments to apply these methods with a reasonable degree of confidence. In the manufacturing example referred to above it might be necessary to adjust for different expenditures on capital equipment or for different levels of stock etc.

1.6. Profit split method

If a licensee of an intangible asset contributes significant value to the intangible through their efforts, then the CUP, RPM and cost plus methods may no longer be applicable to determine the royalty to be paid to the licensor. The local entity will require an arm's length reward for their intangible assets. When both parties to the agreement contribute intangible assets there is no longer a company without intangibles to select as the tested party. In such circumstances, the transactional net margin method (or comparable profits method in the USA) by itself is likely to be unsatisfactory and it may be necessary to use the profit split method albeit that assessing royalty rates is problematic.

When applying the profit split method to intangible assets a residual profit split method is generally more appropriate than a total profit split method. For example, if we consider the position of Manufacturing Co. referred to above but assume that the Manufacturing Company is itself the owner of unique manufacturing know-how, then the first step in applying the residual profit split method could establish the normal market returns that would be derived from the manufacturing process, perhaps through use of the CPM/TNMM. This expected return would then be subtracted from the total forecast profit to leave the residual profit. The residual profit would then be divided between the two companies in accordance with the contribution of each of the two companies in earning this residual profit. The determination of relative contribution is inevitably partly subjective but proxies for value such as relative contribution to the cost to each party of developing intangibles may be used.

1.7. Unspecified methods

As with transfers of tangible property, an unspecified method may be applied if it provides a reliable measure of an arm's length result. It will therefore normally be necessary to analyse the potential application of traditional methods and then determine whether an unspecified method can provide supplementary analysis to help in the determination of an arm's length price.

One way to determine the value of an intangible to an affiliated party is to analyse the realistic alternatives available to that party at the time of transfer; for example, in the case of some intangibles such as software, it might be possible to arrive at a reasonable estimate for the cost of developing this software as an alternative to paying for the right to use the software. One difficulty with this approach is that it could require the addition of a premium, above the estimated cost of development, to take account of the fact that licensing would allow immediate entry to a market compared with development which necessarily involves some delay.

Another alternative method would be to estimate the net present value of the income stream that the intangible is likely to bring to the acquirer. This type of evaluation will usually involve cash flow modelling and capital asset pricing models may also be relevant.

However, these possibilities do not permit the tax authorities to restructure the transaction which the taxpayer actually established, or to replace it with some alternative transaction. The question is not whether an independent party would or could have entered into the arrangement under examination, but what return they would have expected if they had done so.

In a number of cases in the USA, the court has preferred the opinion of expert witnesses rather than rely on unsatisfactory comparables in determining an arm's length royalty rate. As a result, this is an area in which it can be very beneficial to utilise consultants with spechic industry knowledge to determine appropriate rates.

In other cases, 'rules of thumb' have been used to set royalties. For example, some research in the USA indicates that approximately 25% of pre-royalty operating profits were derived by licensors and 75% by licensees. There are also publications which set out ranges of royalty rate by industry sector, allowing a very rough and ready application of the comparable uncontrolled transaction method.

1.8. Hindsight

To the extent that any method used to set royalty rates for a number of years relies on projections and forecasts, its reliability will depend on whether the projections represent a realistic, assessment of future profitability − a difficult thing to demonstrate. To get round this problem, tax authorities may wish to take advantage of hindsight. J. R. Mogle quotes a UK tax inspector as saying 'actual profits are the best indicator of what a prudent and knowledgeable business acting at arm's length might have foreseen likely when signing the agreement.' The OECD is against the use of hindsight. It holds that the transfer price should be examined and defended on the basis of the forecasts prepared at the time the price was set. However, tax authorities fear that MNCs may set royalty rates which are appropriate to the early period in the use of an intangible, but which significantly underestimate its returns when fully deployed. Thus, hindsight may be appropriate as a means of evaluating the reasonableness of the transfer price at the time the transfer price takes place. For example, the US regulations use a 'commensurate with income' concept and provide a safe harbour if the forecast income is within a band of plus or minus 20% of actual income. Taxpayers may mitigate this problem by:

- adopting shorter term agreements;
- including price adjustment clauses in the terms of the agreement (e.g. by linking the level of royalty to the level of production or sales); or
- including clauses which allow for profit fluctuations across several years.

In practice, considerable difficulties remain in setting transfer prices for the transfer of intangible assets. In any case of significant doubt or difficulty, where two revenue authorities

could come to a different view based on the same facts and where substantial amounts of tax are at stake, it may be appropriate to apply for an advance pricing agreement.

2. Automotive industry

The automotive industry is a high profile, high value industry in which globalisation and consolidation raise a range of challenges and opportunities. Like the pharmaceutical industry, the automotive industry makes a large investment in R&D each year, has substantial value in brand awareness and undertakes high volumes of intra-company import and export transactions. These industry characteristics mean that the transfer pricing can significantly affect profits. Hence, companies within the automotive industry, whether assemblers or component manufacturers, risk investigation into their transfer pricing policies. Some of the transfer pricing issues facing the automotive industry are discussed below.

2.1. Competition

The international automotive industry is fiercely competitive, with market forces placing constant pressure on companies to lower prices to maintain market share. In Europe, capacity in the industry currently exceeds consumer demand. In a price-cutting environment, either the manufacturer, the distributor or both must bear the ensuing reduction in profits, with the result that the taxable profitsin in at least one of the countries concerned will suffer. In many cases it is losses which are being allocated. Each country of operation will strive to protect its tax base, and companies potentially face transfer pricing examinations in every country in which they operate.

Competition also enhances the need for information and the release of new models. The product lifecycie of each new model can have a major impact on profitability. At any point in time profits will depend on the number of new models that exist. At tne beginning of the model lifecycle there are low sales and high launch costs that may not be reversed for a number of months or years. Many companies have moved towards single sourcing of components/models in order to control costs and remain competitive. Single sourcing can increase the volume of inter-company transactions in materials and decisions have to be taken on whether to retain the savings achieved by centralised buying within the sourcing entity or to transfer the benefit to the group companies which use the materials.

2.2. Intellectual property

Automotive industry investment in R&D raises a number of transfer pricing issues in respect of intellectual property. It is important to ensure that the location of the ownership of design rights to global models is both tax efficient and compliant with transfer pricing regulations. Chapter 4 explained the fundamental issues involved. There are two main strategies. The MNC can either own the intellectual rights in one location and charge royalties to group members for use of the designs or develop a cost sharing arrangement at the outset so that group members contribute to a proportion of the R&D costs. For example, the pricing of engines and other major components will vary depending upon who owns the design rights to those parts. The rights may be owned by a company that licenses the engine designs to the vehicle assembler, or by an assembler who has the global design rights and uses an engine manufacturer to produce them, or may be shared by some means.

Difficulties may arise when establishing new manufacturing ventures in emerging markets. This inevitably creates a transfer of design rights and manufacturing know-how which will require the payment of an appropriate royalty by the new manufacturing venture. Such royalty payments may give rise to withholding taxes or may not be deductible in computing taxable profits in the country making the payment. These problems may be

reduced by limiting the activity in such markets to contract manufacturing or basic assembling.

2.3. Transfer pricing methods

Various difficulties arise when compiling a transfer pricing strategy for automotive companies. It is difficult to apply the gross margin methods (cost plus or resale price minus) due to the lack of publicly available information on gross margins of comparable companies. It may also be difficult to apply the CPM or TNMM methods to distribution activities since integration during the 1990s within the industry has lead to the disappearance of third party comparable automotive distributors. This integration process means that there are fewer and fewer comparables to choose from when assessing the arm's length range.

A key feature of the industry is the losses made by many vehicle manufacturers, with higher profit margins made on the sale of parts as the vehicle ages. However, the two parts of the business are usually integrated. This makes it difficult or even impossible to split the two parts of the business when looking for comparables to determine arm's length margins and combined margins have to be used. Many major vehicle manufacturers are also aligned to large lending institutions in order to provide hire purchase finance to customers, which is a further function which must be taken into account when finding comparables.

3. Telecommunications industry

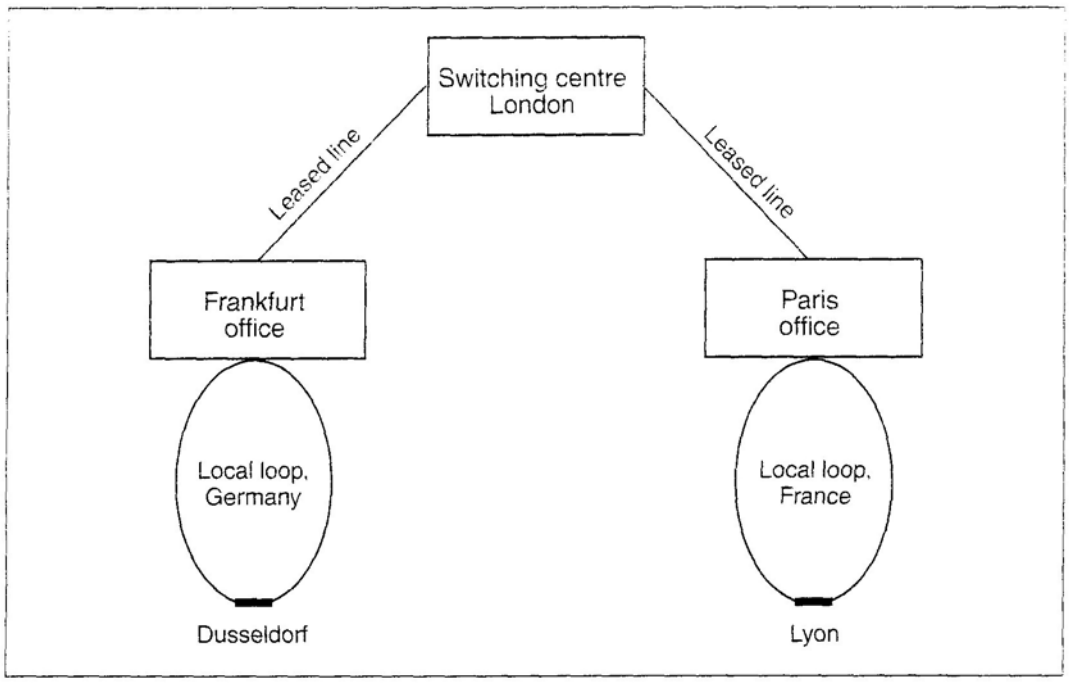
The quotation above refers to plans recently announced by British Telecom and AT&T to embark on a joint venture typifying the industry's move away from its traditional base of national monopolies towards an industry characterised by collaboration, investment, cost-cutting and innovation. Hardly a month goes by without an announcement of a new joint venture or strategic alliance somewhere in the world, as more acquisitions, mergers and mutual trade agreements take place. As a result, competition has never been more intense in the telecommunications industry with rapid growth and expansion into new international markets opened up by deregulation and more technically advanced communications systems.

As telecommunications companies expand in this way, they have to decide how global profits should be apportioned among the individual entities within the group from both commercial and tax perspectives. Some of the transfer pricing issues facing the telecommunications industry are set out below.

3.1. Setting transfer prices

At first glance, setting transfer prices on an arm's length basis in the telecommunications industry does not appear to be too imposing a task. The number of price lists and tariffs available to customers which might serve as a source of comparison is enormous. However, the example of a UK multinational with a switching centre in London connected by leased lines to offices in Frankfurt and Paris and using local loops in Germany and France to complete calls will illustrate the complexities of transfer pricing in telecommunications. The situation is represented in Figure 3.1.

Fig. 3.1 − Route of telephone call between Dusseldorf and Lyon



Thus a call between Dusseldorf and Lyon passes through two local loops, two local offices, two leased lines and the UK switching centre. In setting transfer prices, the challenge is to apportion the total revenue on all such calls such that the MNC's companies in the UK, Germany and France receive an arm's length return on their functions and assets which generate and facilitate the calls. These functions and assets will include the line leasing, switching centre and local call termination and may include valuable intellectual property such as patent rights and brand name. The payments to the three MNC companies for their contributions could be arrived at using any of the accepted transfer pricing methods such as CUP, cost plus or profit split depending partly on the availability of comparable data and partly on whichever method is readily implemented. The decision as to how the revenue on such calls should be divided can therefore make a considerable difference to group profit especially when (as in this example) the higher tax rates in France and Germany are taken into account. Obviously, the problem is considerably greater at a global level when a large number of related and unrelated entities may be using a network which is owned in different proportions by many of the entities.

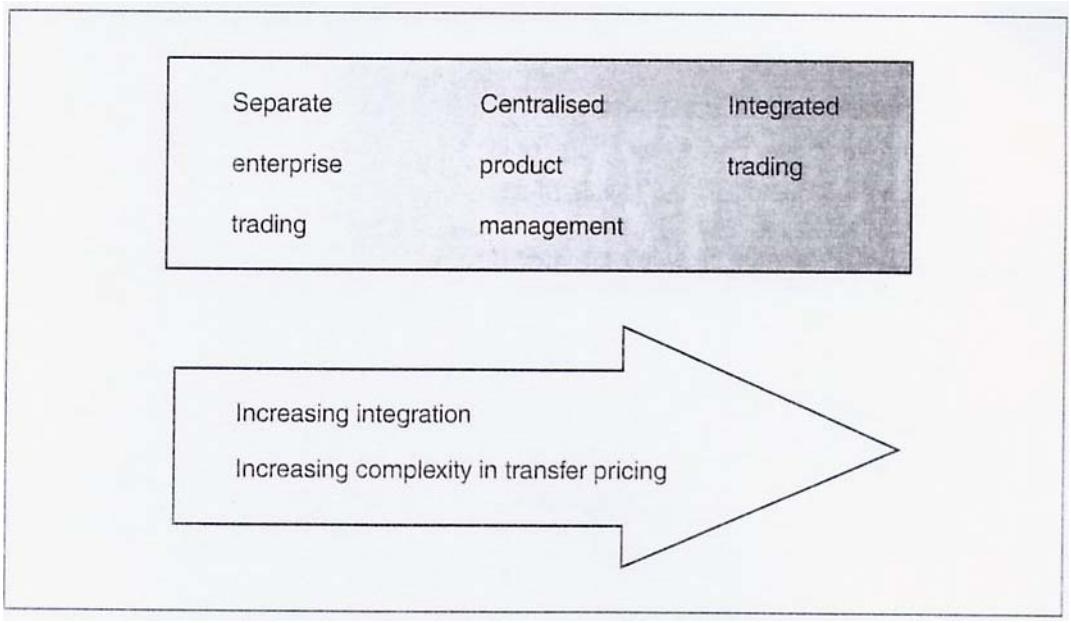
The objective in dealing with this type of complexity is to develop transfer pricing policies that adequately recognise the group transactions being undertaken, that are defensible in the case of a challenge from the tax authorities, and yet are simple to operate and are tax efficient. It is especially important to define which entity or entities should own the network, be responsible for development and re&p the lion's share of the ultimate profits or losses that will be earned by the group.

4. Global trading of financial instruments

Financial markets in both primary and derivative instruments have now developed on a global basis. The OECD describes three types of trading arrangements by which financial institutions may organise global trading of an increasing variety of financial instruments. The three types − integrated trading, centralised product management and separate enterprise

trading − are not in reality completely different approaches but rather stages along a continuous range (see Figure 4).

Fig. 4 − Global trading models − OECD descriptions



In separate enterprise trading, each location within the multinational financial institution operates as a separate profit centre with its own marketing, trading and back office staff. At the other extreme, integrated trading occurs when traders in a number of centres set prices and trade on a commonly held portfolio of positions in a variety of instruments.

This portfolio is often referred to as the book. The book may be passed from one location to another as markets open and close, or different locations may trade on it simultaneously. Centralised product management is a half-way house, where products are managed separately but on a global basis.

The OECD 1998 Report on Global Trading affirms the OECD view that traditional transaction-based transfer pricing methods (CUP, RPM, cost plus) are the preferred ways to determine arm's length pricing in respect of financial products. However, the report acknowledges that while these transactional methods can be effective for determining taxable profits by territory in many cases of global trading, they may be ineffective when applied to more exotic financial products or when fully integrated global trading is in operation. With integrated trading, there are problems in allocating profits between locations, since trading and management occur worldwide, and problems in allocating profits between products arise since they may be mutual hedges.

The OECD 1998 Report offers various potential solutions to these problems, such as:

- measuring the value of activity in each location in proportion to the extent of trading activity in the location or the remuneration earned by its key marketers and traders;
- measuring the amount of risk to which the worldwide organisation is exposed by each location; or
- measuring the risk management functions provided in each location.

Each of these approaches has merits and defects and the OECD acknowledges that there is considerable disagreement among its member nations about the preferred approach. The OECD continues to give this problem active consideration and further commentary from the OECD can be expected in the future. It is likely that this will lead eventually to an additional chapter or chapters in the OECD Guidelines to deal specifically with the transfer pricing issues of global trading.

The US published Proposed Regulations Governing Transfer Pricing for Global Dealing Operations in March 1998. These will influence the effective worldwide tax rate of financial multinationals with operations in the USA by carving up their worldwide financial products income between the USA and the rest of the world. The regulations will therefore impact upon their international tax planning strategies. Until the publication of the Proposed Regulations many financial institutions were forced to use financial product APAs to ensure their tax treatment because of an 'all or nothing' rule on the sourcing of income which allocated all of the income to a US branch which had a material participation in a transaction. The new regulations will provide greater certainty for financial institutions with US branch operations, although APAs will remain useful for companies with more complex financial products and for those uncertain about the interpretation of the new rules.

The Proposed US Regulations incorporate the 'best method' approach to determine the arm's length allocation of income from global dealing operations. The general methods from the section 482 regulation are recommended with some modifications and one method notably missing is the comparable profits method. This is the method favoured by the IRS for many other types of business.

Taken together the 1998 OECD and the Proposed US Regulations highlight several apparent differences between the US and many of the other OECD members. The main problem area is in the treatment of capital, and particularly the extent to which the capital, of a company should be recognised as a reward-earning factor in calculating the taxable profit of a branch carrying on part of a global trading activity The absence of a consensus on this issue among the jurisdictions where global trading is a significant activity may explain why the USA has not finalised the Proposed Regulations at the time of writing.

Abstract:

Transferovou cenou (převodní cenou) rozumíme obvykle cenu, která je realizována při obchodu mezi subjekty, jež nejsou nezávislé, tzn. jsou určitým způsobem propojené, spřízněné, velmi často jsou součástí majetkově propojené skupiny společností (holdingu, koncernu apod.). Lze očekávat, že cena dohodnutá mezi takovými subjekty může být ovlivněna jejich vzájemnými vztahy a v konečném důsledku se může odlišovat od ceny, která by byla sjednána ve srovnatelném obchodu mezi subjekty nezávislými. Transakce však musí splňovat princip tržního odstupu, tj. probíhat za stejných či obdobných podmínek jako transakce s nezávislými subjekty v běžných obchodních vztazích.

Použitá literatura:

1) Brakman, S., Marrewijk, Ch.: The economics of international transfers, Cambridge University Press, Cambridge 1998. ISBN 0-521-57214-2.
2) Dvořáček, J.: Společné a nadnárodní podniky, Oeconomica, Praha 2006. ISBN 80-245-1029-4.

Školitel: Doc. Ing. Hana Pačesová, CSc. *(Ústav řízení a ekonomiky podniku FS ČVUT)*