

# ALDER&SOUND

Alder & Sound | Eteläesplanadi 8 | FI-00130 Helsinki | [firstname.lastname@aldersound.fi](mailto:firstname.lastname@aldersound.fi) | [www.aldersound.fi](http://www.aldersound.fi)

*The Tier 1 Finnish Tax Firm in 2018 & 2017 | The Finnish Transfer Pricing Firm of the Year in 2017, 2015 & 2011 | The European Tax Technology Firm of the Year in 2017*

# Introduction to transfer pricing

Aalto BIZ / 32E30001 Tax Challenges for Multinational Enterprises | April 16, 2019 | Petteri Rapo

# Agenda | April 16, 2019

Introduction to transfer pricing

1. Introduction & overview
2. National and international regulatory framework
3. Key concepts & terminology
4. Transfer pricing in practice
5. Future outlook for transfer pricing



# The key dilemma in international taxation for the past 80 years

Division of taxing power between sovereign states in case of cross-border business activities

3

alternative solutions:

- 1) Separate entity approach (& arm's length principle)
- 2) Formulary apportionment
- 3) Presumptive taxation



# Why is transfer pricing such a big deal?

Transfer pricing is one of the key areas of international taxation

Up to

# 60-70%

of annual world trade takes place within multinational enterprises.

## IMF, World Bank, UN, OECD unite to fight tax evasion

The 4 organizations announce a joint platform for collaboration on tax issues

BUSINESS

## Coca-Cola Owes \$3.3 Billion in Taxes Over Foreign Transfer Licensing

An audit found reported income from 2007 to 2009 should have been higher

## Nokia Case Highlights India Tax Regime Risks

**nokian  
TYRES**

Nokian Tyres received EUR 73.3 million additional payable tax in Finland regarding years 2008-2010; the company will make a complaint against the decision

## India Court Backs Vodafone in \$1.3 Billion Tax Spat, BTVI Says

## Shell wins tax battle against Indian authorities

August 29, 2014 4:43 am JST

Honda prevails against tax authority in transfer pricing dispute

🕒 19 November 2014 | Business

August 19, 2013 7:48 pm

## Vodafone agrees multimillion pound deal with HMRC for royalties

# National and international regulatory framework

The regulatory framework for transfer pricing consists of both national and international guidelines and legislation

## ► OECD:

- Model Tax Convention on Income and on Capital (Art. 9: Associated enterprises & Art. 25: Mutual agreement procedure)
- Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

## ► UN:

- Model Double Taxation Convention between Developed and Developing Countries (Art. 9: Associated enterprises & Art. 25: MAP)
- Practical Manual on Transfer Pricing for Developing Countries

## ► EU: Joint Transfer Pricing Forum (JTPF)

- Code of conduct for the effective implementation of the Arbitration Convention
- Code of conduct on transfer pricing documentation for associated enterprises in the EU
- Guidelines for Advance Pricing Agreements (APAs) in the EU
- Guidelines on low-value-adding intra-group services
- Potential approaches to non-EU triangular cases
- Report on Small and Medium Enterprises (SMEs) and Transfer Pricing
- Report on Cost Contribution Arrangements on Services not creating Intangible Property (IP)
- Report on Secondary Adjustments
- Report on Transfer Pricing Risk Management
- Report on Compensating Adjustments

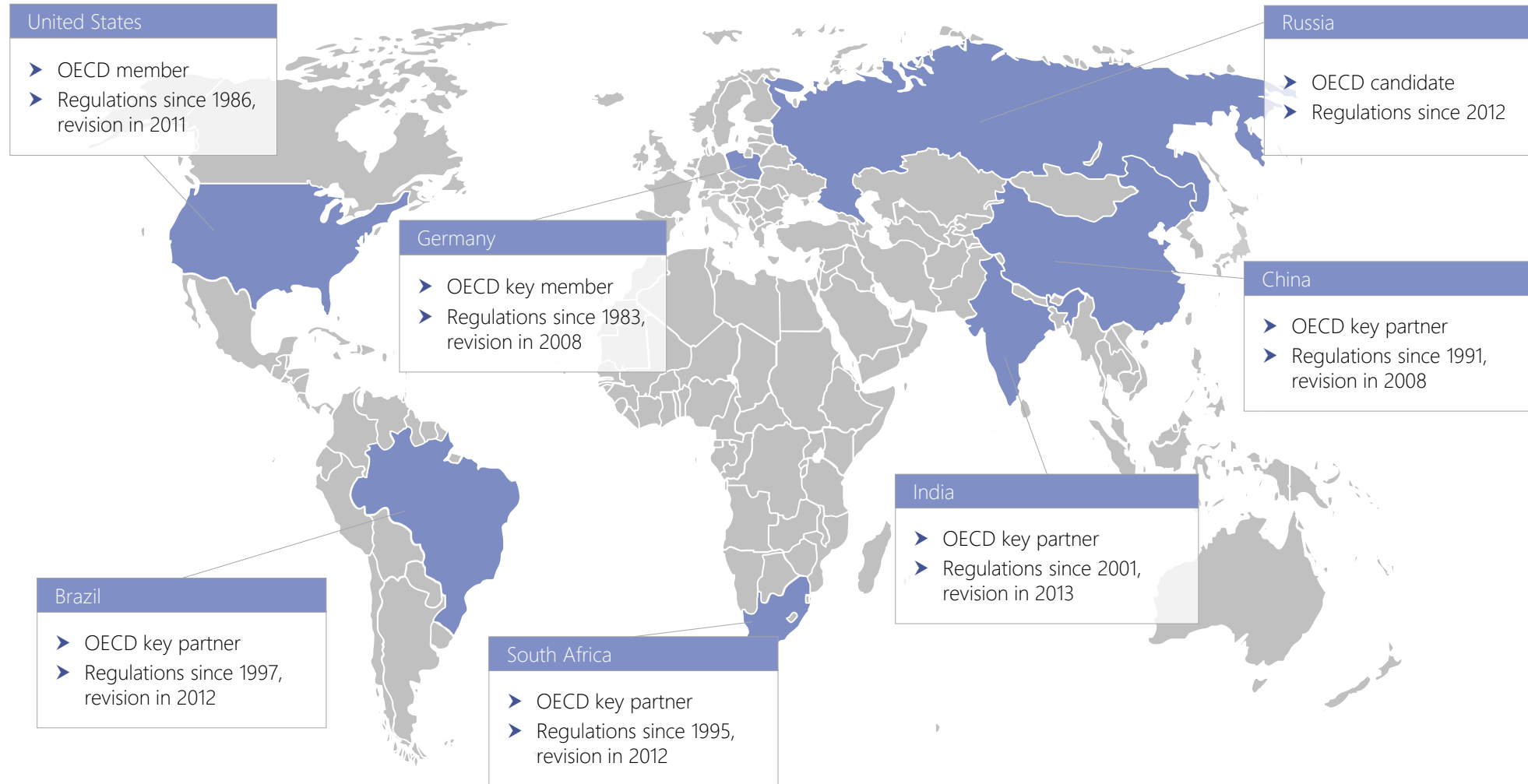


Finland:

VML 14 a-c §,  
31 § & 32.4 §  
+  
tax treaties

# National and international regulatory framework (cont'd)

The amount of countries with national transfer pricing legislation has steadily increased since 1990s



# Key concepts & terminology

Transfer pricing | Arm's length principle | Associated enterprises

## ➤ Transfer pricing

Transfer pricing refers to the setting of the price for goods, services, intangibles and financing sold or transferred between associated (or related) parties (legal entities) within a multinational enterprise (MNE).

## ➤ Associated enterprises (also related or affiliated parties)

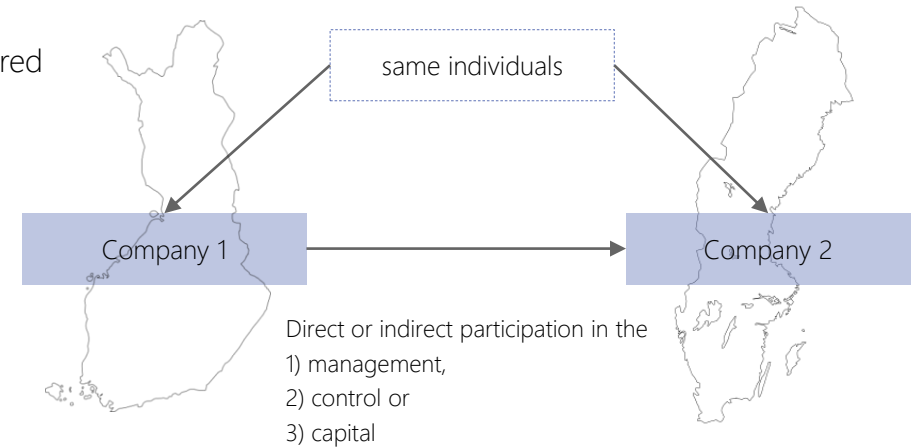
Two enterprises are associated enterprises with respect to each other if one of the enterprises meets the conditions of Article 9 of the OECD Model Tax Convention with respect to the other enterprise.

## ➤ Separate entity approach

The method selected by the OECD member countries for achieving equitable results and minimizing the risk of unrelieved double taxation. Under the approach, each individual group member in an MNE is subject to tax on the income arising to it (on a residence or source basis)

## ➤ Arm's length principle

A standard, adopted by the OECD for practical application of the separate entity approach. According to the arm's length principle, transactions between two related parties should be conducted as if the parties were unrelated.





# Key concepts & terminology (cont'd)

Arm's length analysis aim's at aligning transfer pricing outcomes with value creation

## ➤ Functional analysis

The functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to this explicit transaction and then assign the parties to the transaction with economic and tax characterizations.

- **Economic characterization** reflects the managerial perception related to the role of such entity in the value chain. Often utilized economic characterizations are *expense / cost center, revenue center, profit center* and *investment center*.
- **Tax characterization** reflects the relation between functions & risks and the anticipated profit level of a party to the transaction. Often utilized economic characterizations assigned to a party to the transaction are *principal, fully-fledged / full-risk operator, agent / commissionaire* and *limited-risk operator*.

## ➤ Comparability analysis

The comparability analysis refers to comparison of a controlled transaction with an uncontrolled transaction or transactions.

## ➤ Economic analysis

The economic analysis is designed to demonstrate that results of a certain related-party transactions conform with applicable transfer pricing requirements.

+ Supply chain analysis

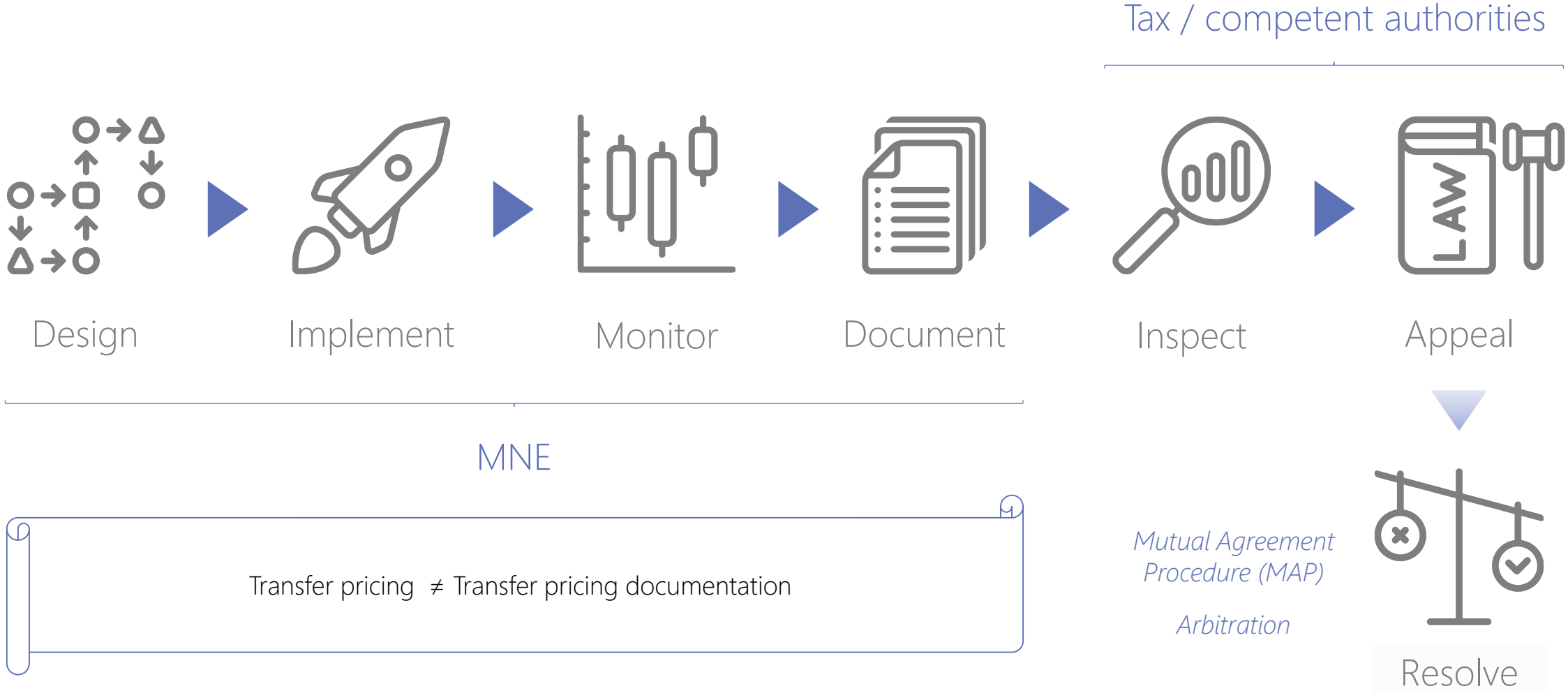
+ Value chain analysis

# Transfer pricing in practice



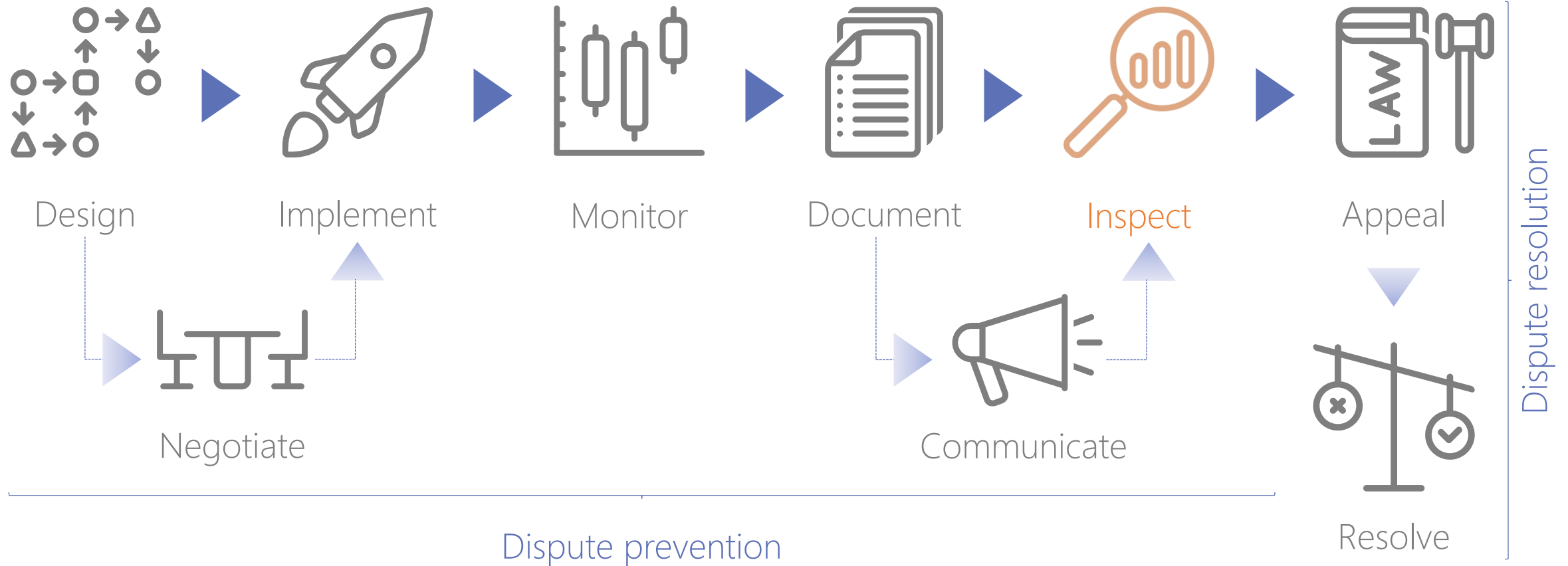
# Overview of the typical transfer pricing process

The different steps of the typical transfer pricing process aim at ensuring appropriate division of taxing power between sovereign states



# Overview of the typical transfer pricing process (in reality)

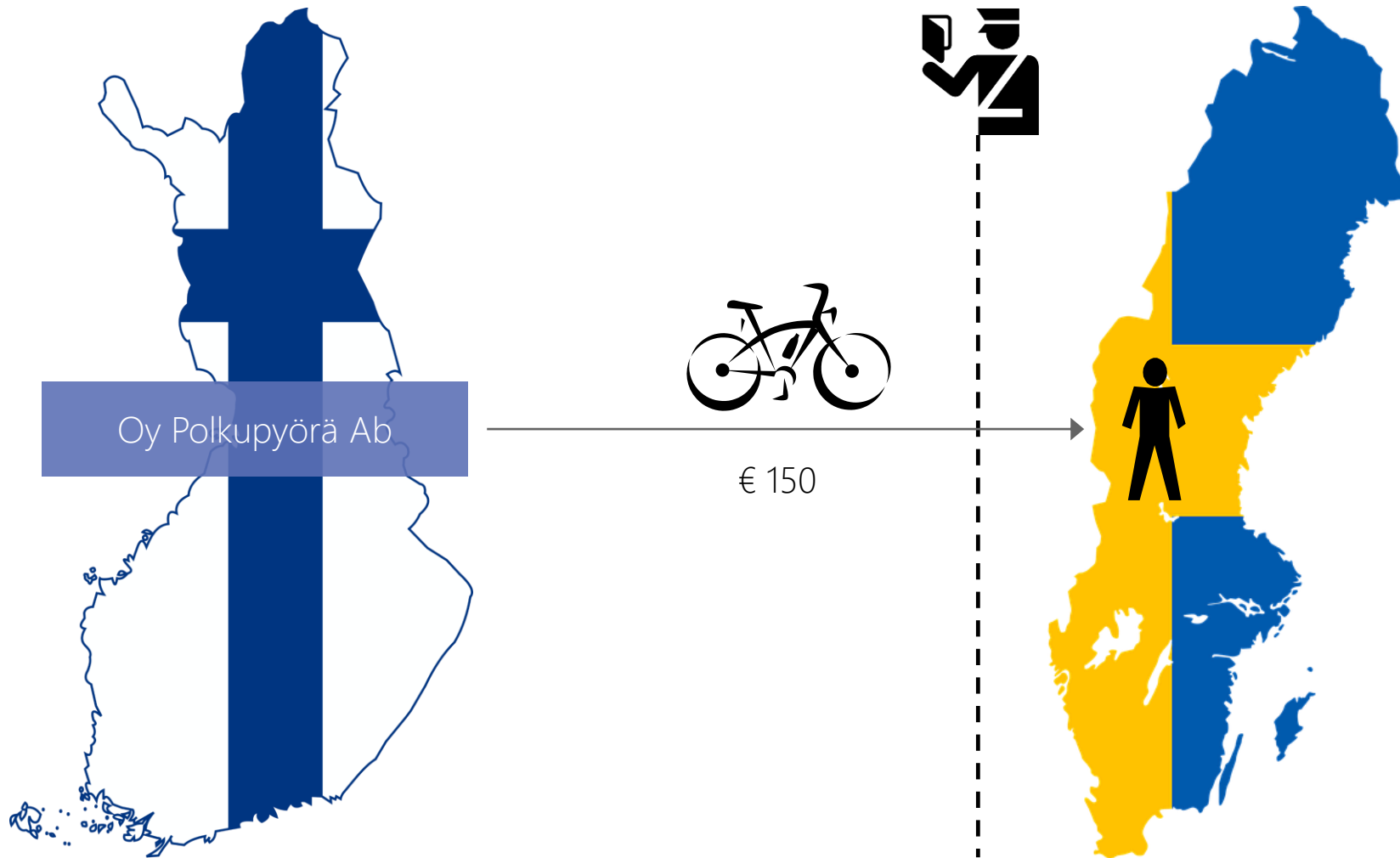
The different steps of the typical transfer pricing process aim at effective dispute prevention in order to avoid dispute resolution





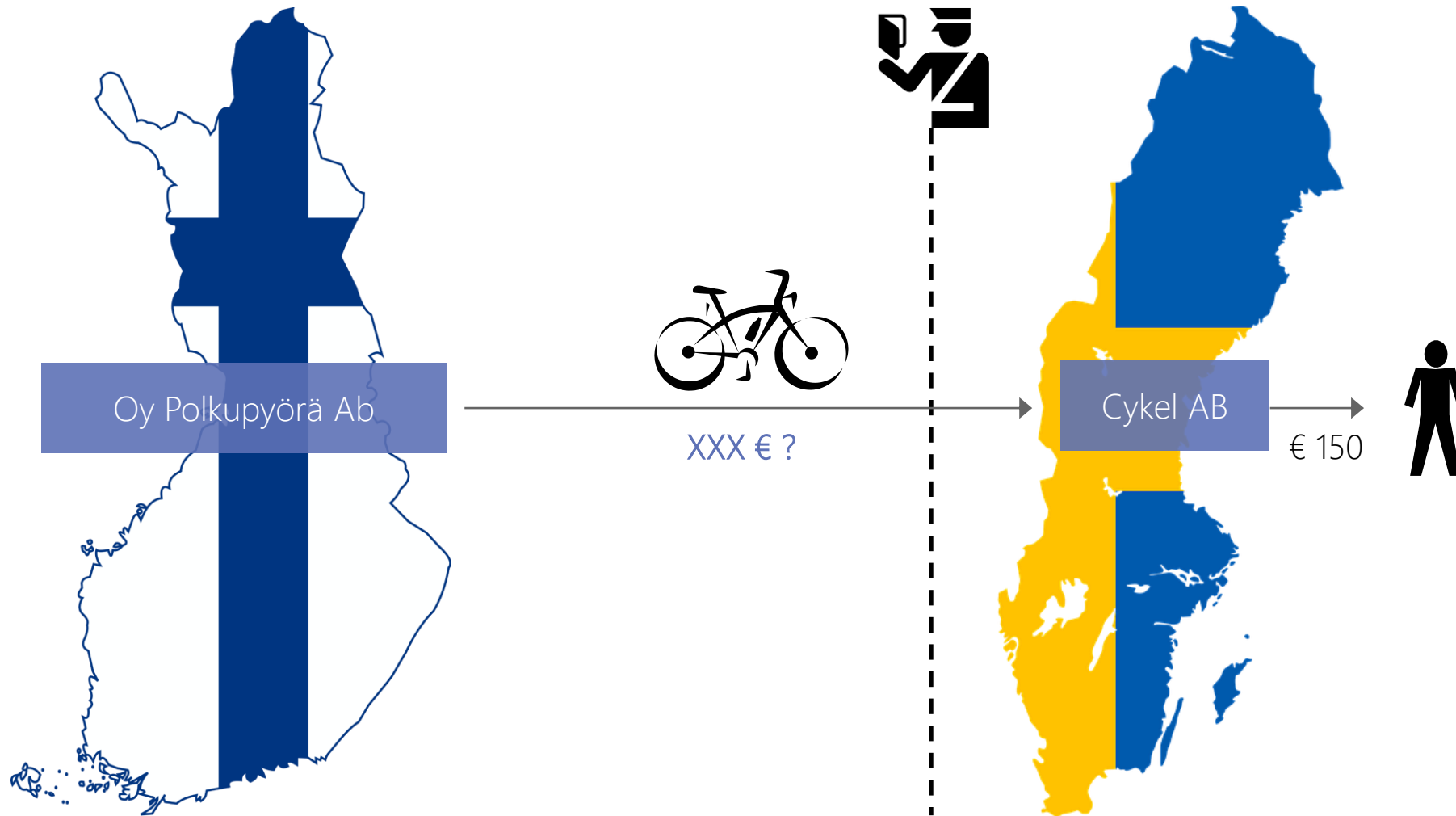
# Domestic transactions vs. cross-border transactions

Cross-border business transactions create the need for division of taxing powers between the sovereign states involved



# Domestic transactions vs. cross-border transactions | Transfer pricing

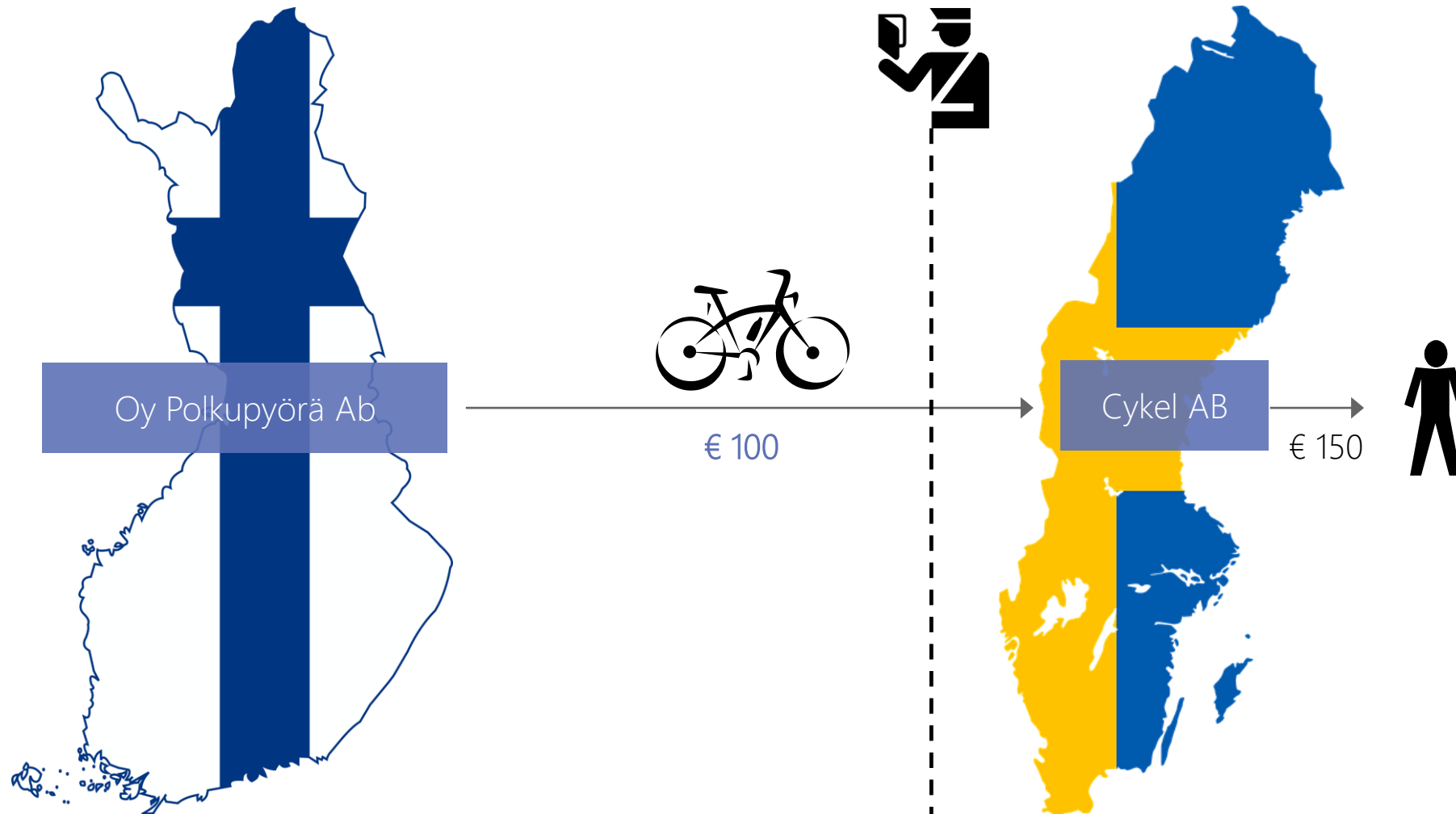
Cross-border business transactions create the need for division of taxing powers between the sovereign states involved





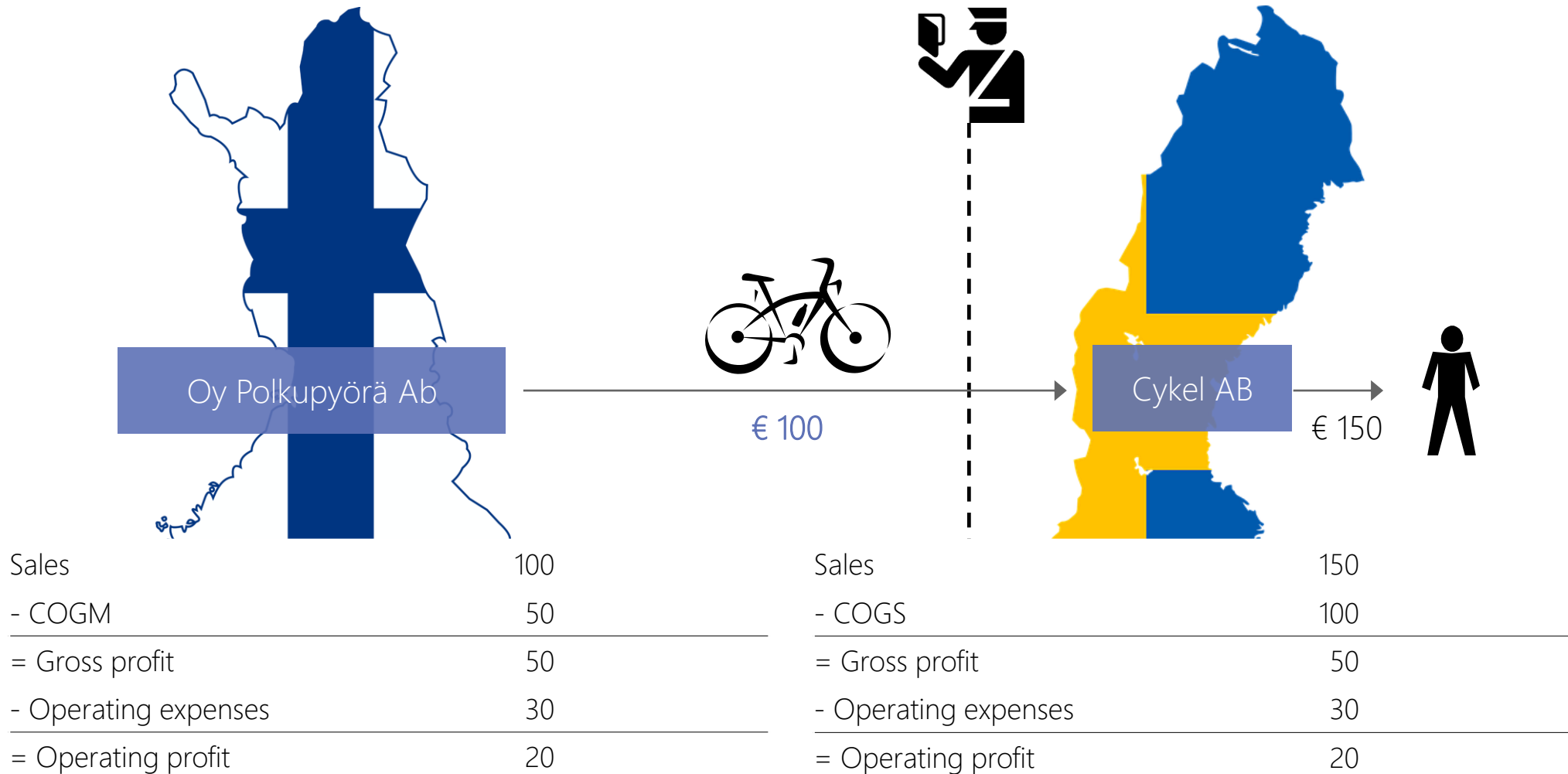
# Setting an arm's length price

Example | The effect of transfer price used in the intra-group transaction on the profitability of the parties



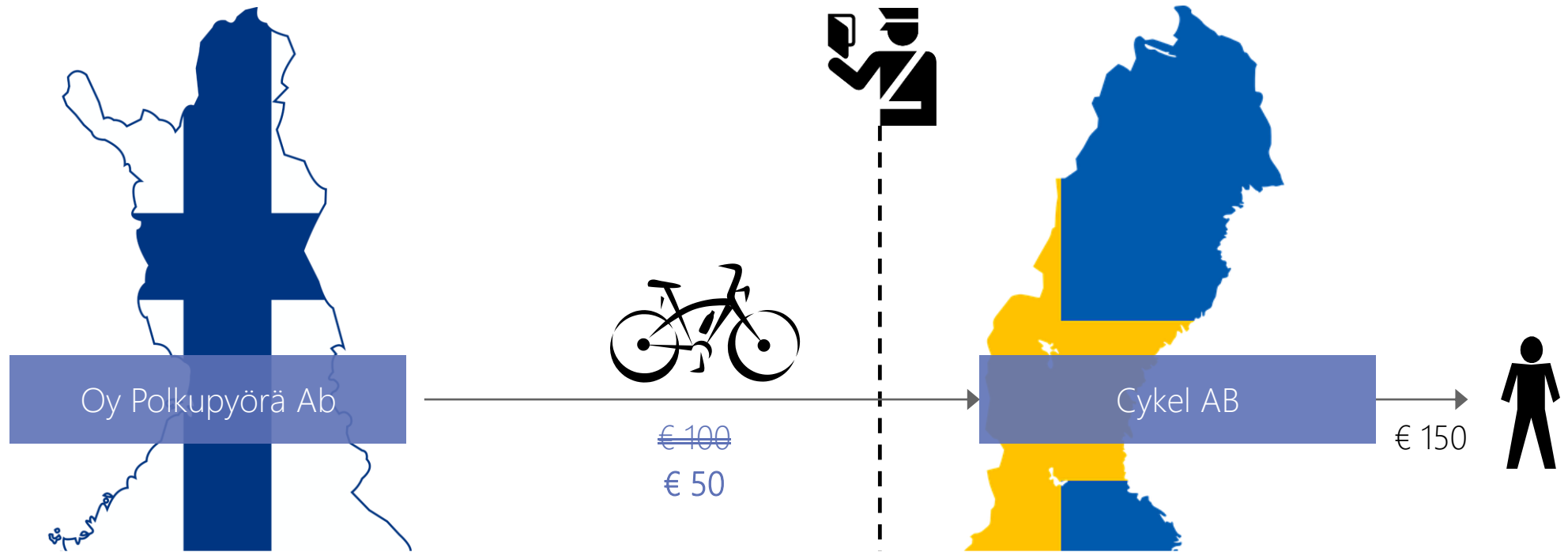
# Setting an arm's length price (cont'd)

Example | The effect of transfer price used in the intra-group transaction on the profitability of the parties



# Setting an arm's length price (cont'd)

Example | The effect of transfer price used in the intra-group transaction on the profitability of the parties

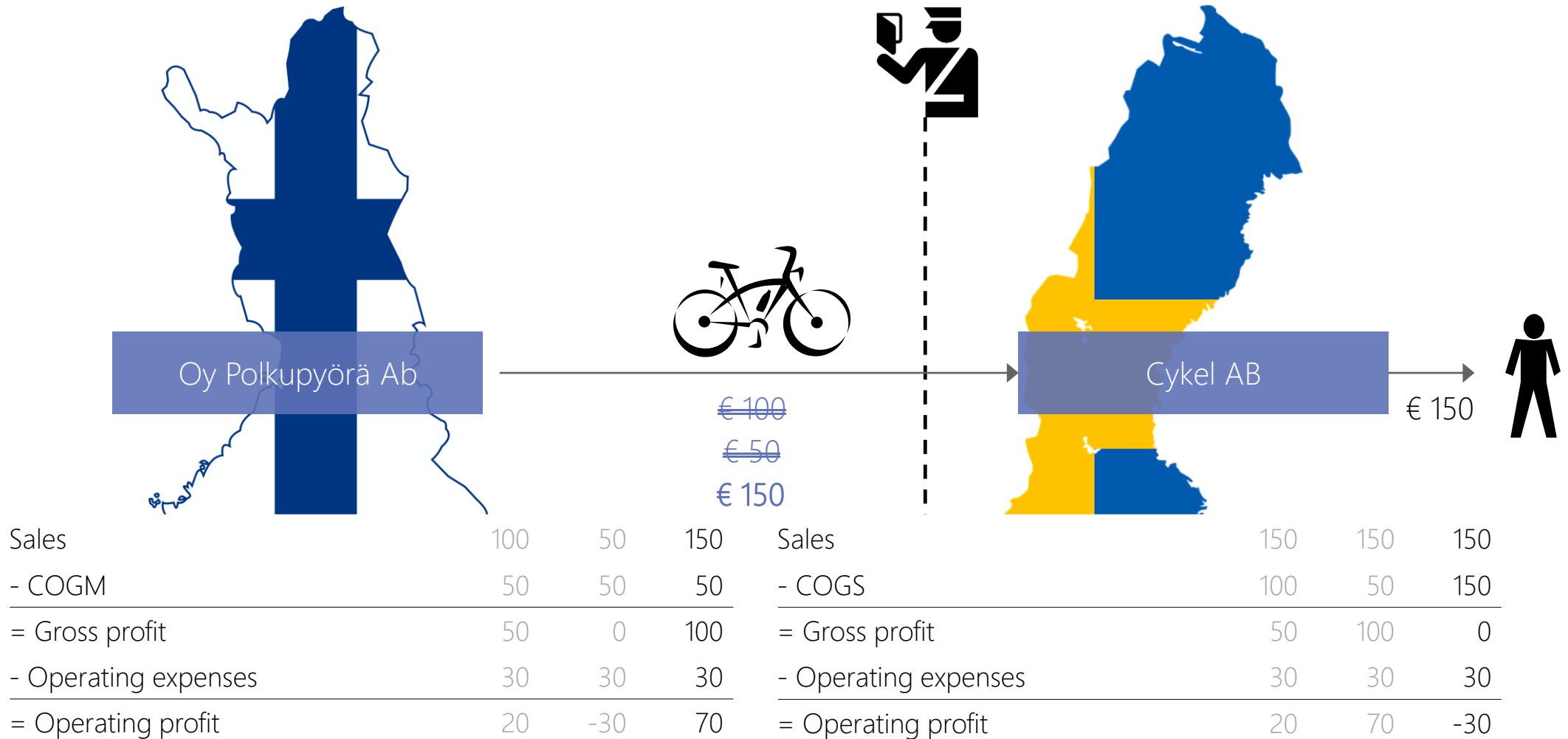


Sales	100	50
- COGM	50	50
= Gross profit	50	0
- Operating expenses	30	30
= Operating profit	20	-30

Sales	150	150
- COGS	100	50
= Gross profit	50	100
- Operating expenses	30	30
= Operating profit	20	70

# Setting an arm's length price (cont'd)

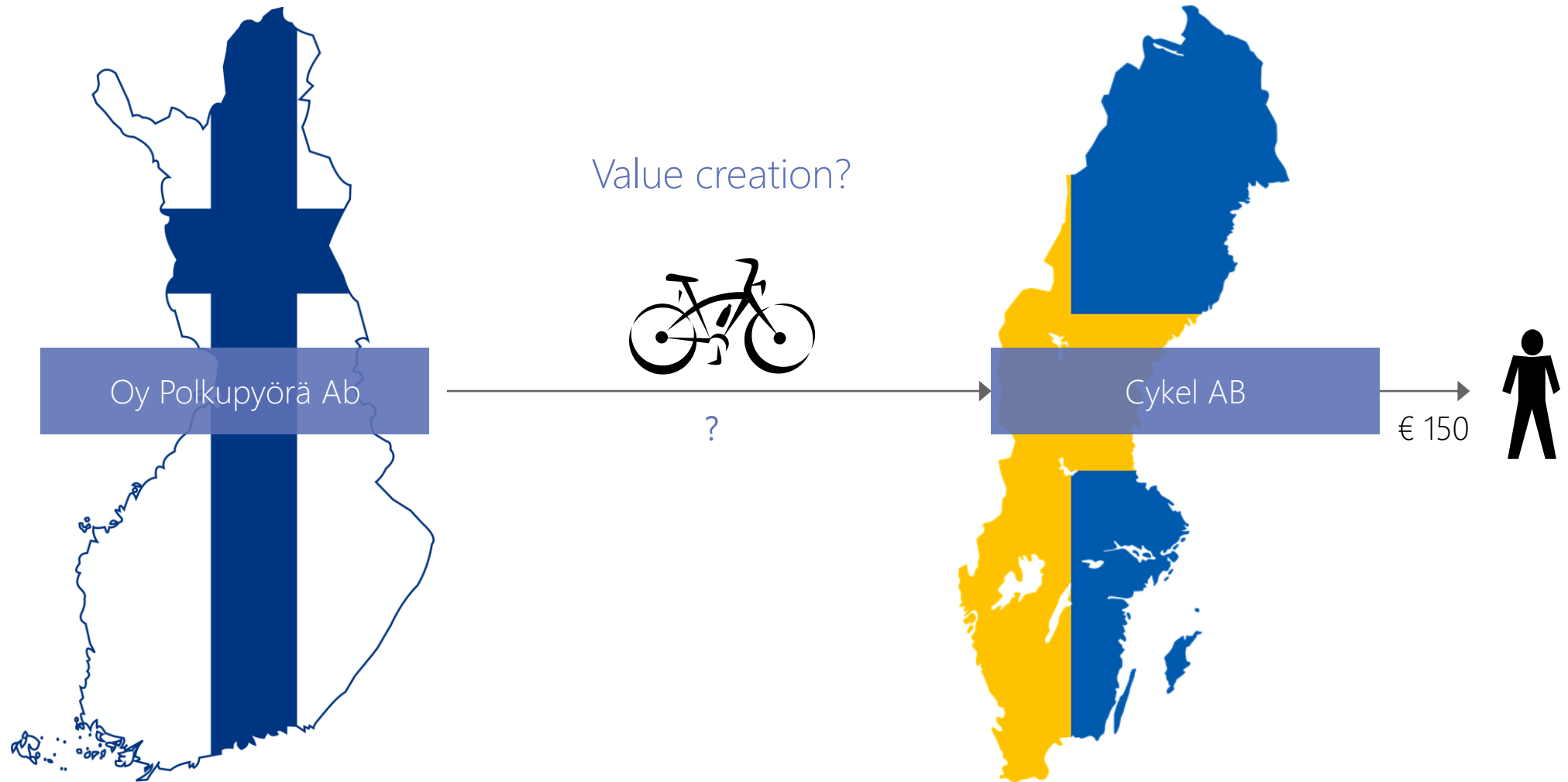
Example | The effect of transfer price used in the intra-group transaction on the profitability of the parties





# Setting an arm's length price (cont'd)

Arm's length analysis aims at aligning transfer pricing and value creation



# Setting an arm's length price (cont'd)

The OECD Guidelines define a number of (external) methods that can be used to determine arm's-length prices for related-party transactions

➤ **Comparable uncontrolled price method (CUP)**

A method of pricing that compares the price for property or services in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

➤ **Cost Plus method (C+)**

A method of pricing based on the costs incurred plus an appropriate mark-up.

➤ **Resale Price Method (also Resale Minus, R-)**

A pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin.

➤ **Transactional net margin method (TNMM)**

A profit-based method that compares the profitability of a taxpayer to the profits of comparable entities undertaking similar transactions.

➤ **Profit Split Method (PS)**

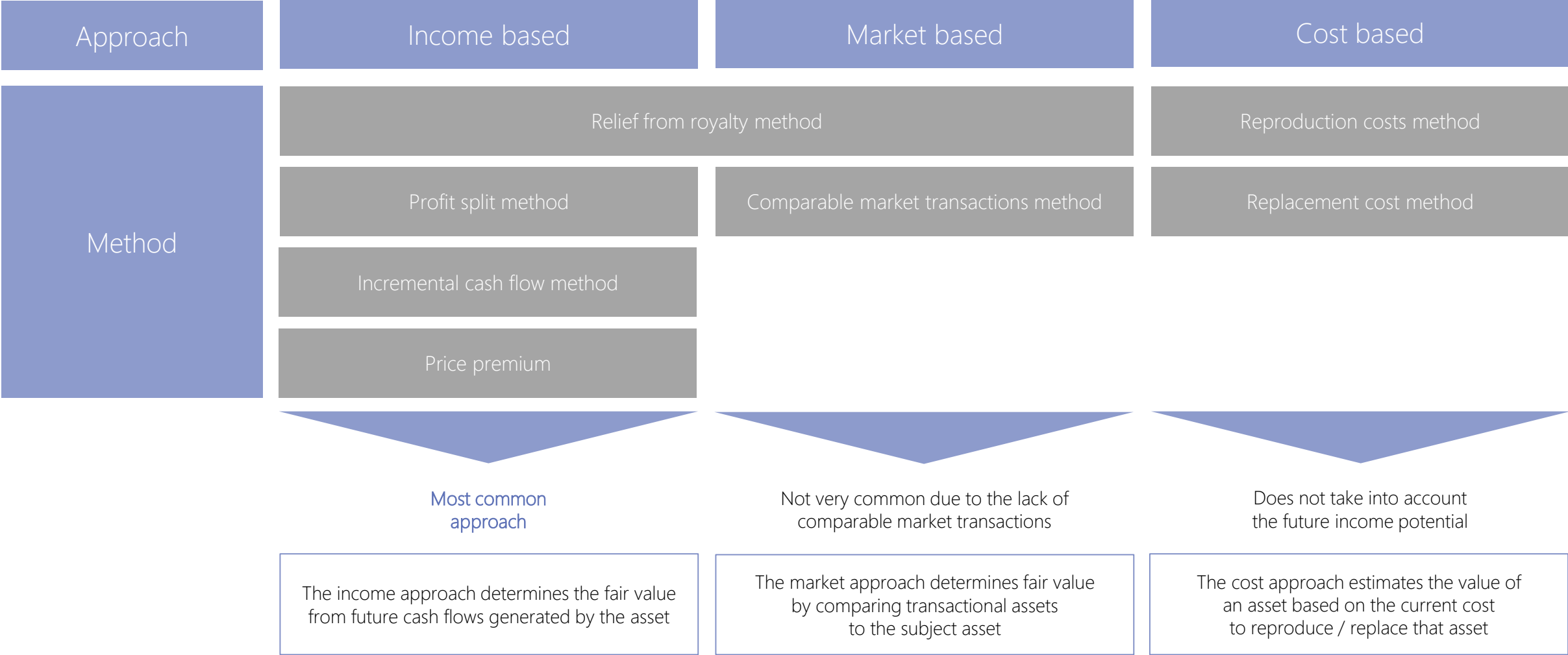
A method of pricing where the profit or loss of a multinational enterprise is divided in a way that would be expected of independent enterprises in a similar, highly integrated relationship (e.g. joint venture).

+ Other methods

- Internal vs. external transfer pricing method
- Economic valuation methods
- OECD / the most appropriate method vs. YK / the most suitable method vs. IRS (US) / the best method -principle

# Setting an arm's length price (cont'd) – Intangibles

Appropriate valuation analysis aims at ensuring arm's length compliance of the transaction involving intangibles (i.e. licensing / transfer)



# Dispute prevention | Transfer pricing documentation

OECD/G20 BEPS: Three-tiered approach to transfer pricing documentation

## Master file

The master file provides an overview of the MNE group business, including the nature of its global business operations, its overall transfer pricing policies, and its global allocation of income and economic activity .

The information required in the master file provides a “blueprint” of the MNE group and contains relevant information that can be grouped in five (5) categories:

- a) The MNE group’s organisational structure;
- b) A description of the MNE’s business or businesses;
- c) The MNE’s intangibles;
- d) The MNE’s intercompany financial activities; and
- e) The MNE’s financial and tax positions.

## Local file

In contrast to the master file, the local file provides more detailed information relating to specific intercompany / related-party transactions.

The information required in the local file supplements the master file and helps to meet the objective of assuring that the taxpayer has complied with the arm’s length principle in its material transfer pricing positions affecting a specific jurisdiction. More specifically, the required information covers the following three (3) categories:

- a) Local entity
- b) Controlled transactions
- c) Financial information

## Country-by-Country (CbC) Report

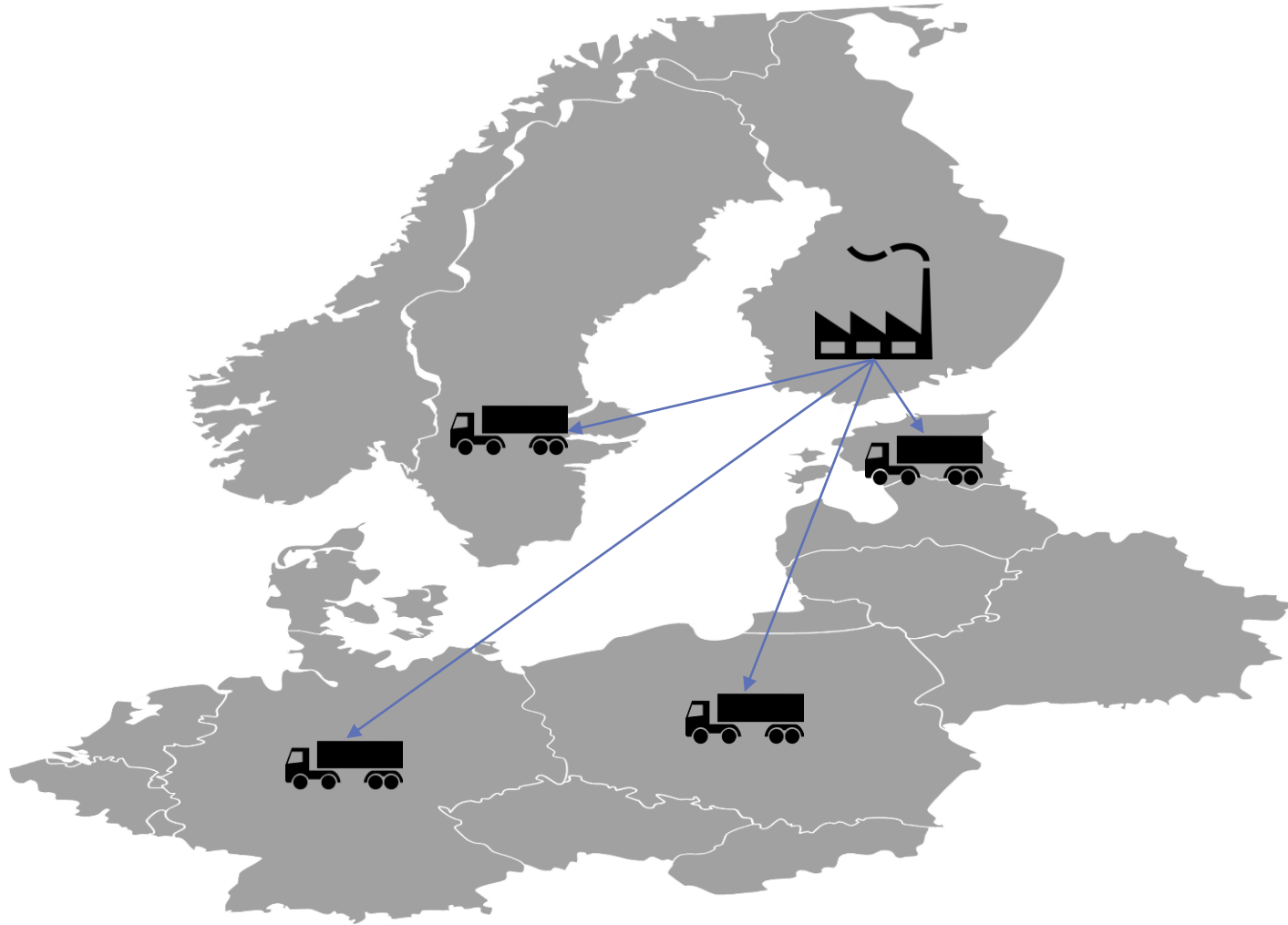
The country-by-country (CbC) report presents aggregate tax jurisdiction-wide information relating to the global allocation of the (i) income, (ii) the taxes paid, and (iii) certain indicators of economic activity among tax jurisdictions in which the MNE group operates.

The CbC reporting is required by MNEs with global turnover exceeding EUR 750 million.



# Dispute prevention | Negotiation

In practice, the only way to reach certainty on interpretation of the arm's length principle in practice is through advance negotiation



Three (3) levels of advance negotiation:

- 1) Local advance ruling / unilateral APA
- 2) Bilateral APA
- 3) Multilateral APA



# Dispute resolution Overview

The cross-border nature of transfer pricing dictates the need for efficient international dispute procedures



- 1) National appeal process (+CJEU)
- 2a) Mutual Agreement Procedure (MAP)
- 2b) Arbitration
- 3) Advance negotiation



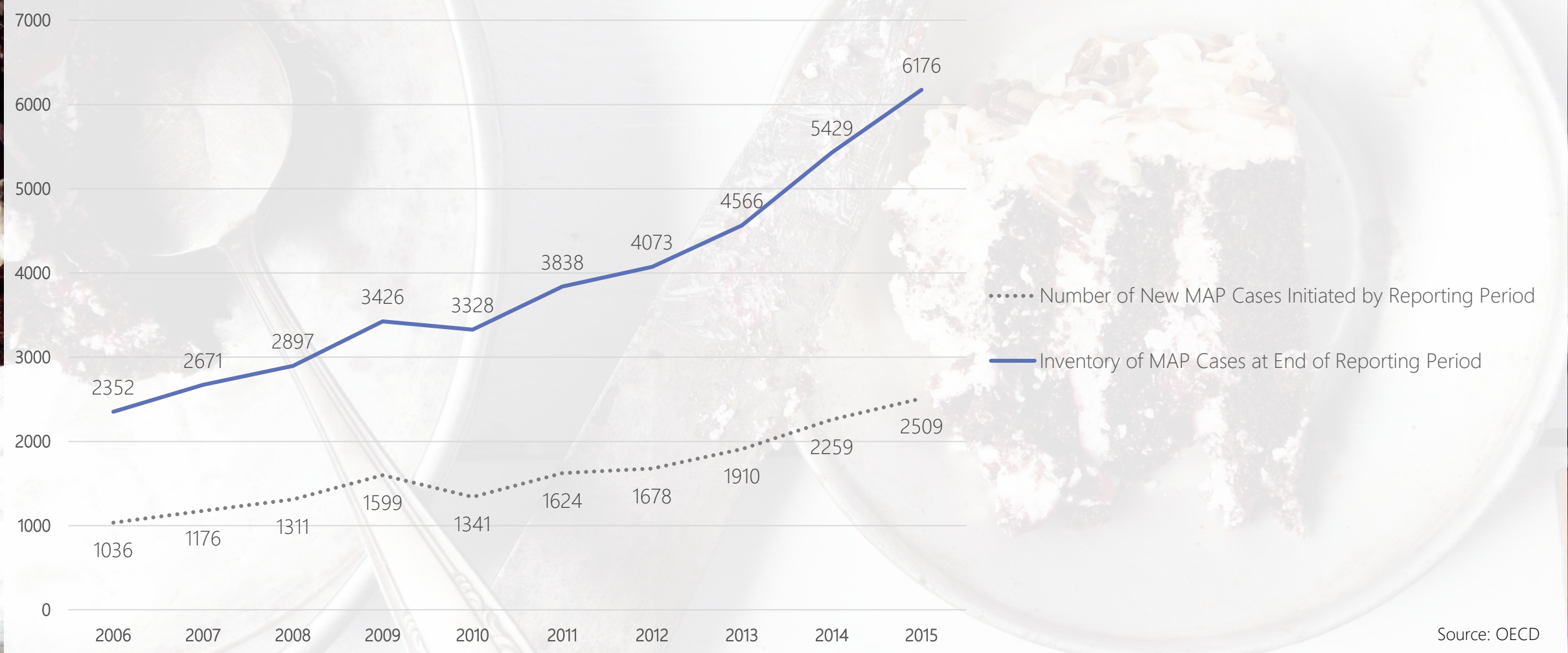
# Mutual Agreement Procedure (MAP)

MAP allows the Competent Authorities of the Contracting States to interact with the intent to resolve international tax disputes

- ▶ **Mutual Agreement Procedure** (*MAP*) allows the Competent Authorities or designated representatives of the Competent Authorities from the governments of the Contracting States/Parties to interact with the intent to resolve international tax disputes.
- ▶ MAP is suitable for both dispute prevention and dispute resolution:
  - **Dispute prevention:** bilateral or multilateral advance agreements (*Advance Pricing Agreement, APA*)
  - **Dispute resolution:** elimination of double taxation
- ▶ MAP is based on corresponding Articles in the bilateral or multilateral tax treaties (Article 25 of the OECD Model Tax Convention).
- ▶ In order to mitigate international double taxation, there are ongoing initiatives to make the intergovernmental dispute resolution more efficient through mutual agreement procedure:
  - **OECD:** Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (*OECD Multilateral Instrument; MLI*)
  - **EU:** Dispute Resolution Directive

# Mutual Agreement Procedure Statistics

OECD Member Countries / 2006-2015



Source: OECD



# Future outlook for transfer pricing

# Future outlook for transfer pricing

The OECD/G20 BEPS Action aims at ensuring that profits are taxed where economic activities are performed and value is created

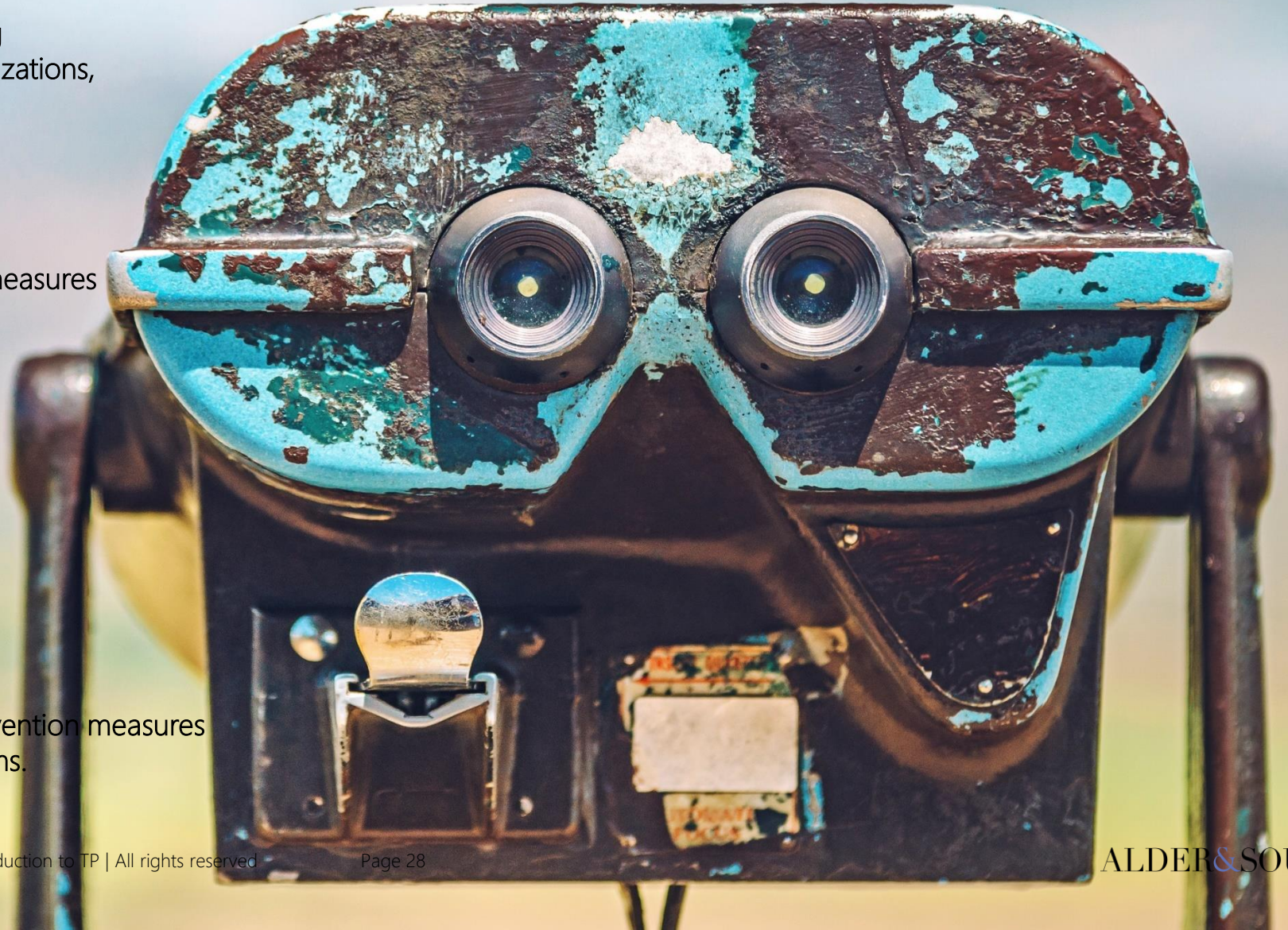
1. Tax challenges of the digital economy
2. Neutralize the effects of hybrid mismatch arrangements
3. Strengthen CFC rules
4. Limit base erosion via interest deductions and other financial payments
5. Counter harmful tax practices more effectively, taking into account transparency and substance
6. Prevent treaty abuse
7. Prevent the artificial avoidance of PE status
8. [Transfer pricing & value creation] Intangibles
9. [Transfer pricing & value creation] Risks and capital
10. [Transfer pricing & value creation] Other high-risk transactions
11. Establish methodologies to collect and analyse data on BEPS and the actions to address it
12. Require taxpayers to disclose their aggressive tax planning arrangements
13. Re-examine transfer pricing documentation
14. Make dispute resolution mechanisms more effective
15. Develop a multilateral instrument



# Future outlook for transfer pricing (cont'd)

The domestic and international transfer pricing landscape is in the state of constant change

- ▶ Increasing interest towards transfer pricing practices of MNEs by supranational organizations, local tax authorities and media
  - Intangibles & intra-group financing
  - Transparency & information exchange
- ▶ National implementation of OECD BEPS measures
  - EU is looking for a more active role within the union
- ▶ Shifting focus towards proactive approach
  - "Culture of compliance"
  - Ex ante vs. ex post
  - Real-time (horizontal) monitoring
  - Advance pricing agreements (APAs)
- ▶ The urgent need for effective dispute prevention measures and efficient dispute resolution mechanisms.





Petteri Rapo | Partner, Transfer Pricing Services

+358 44 333 7252

petteri.rapo@aldersound.fi

Alder & Sound | Eteläesplanadi 8 | FI-00130 Helsinki | [firstname.lastname@aldersound.fi](mailto:firstname.lastname@aldersound.fi) | [www.aldersound.fi](http://www.aldersound.fi)

*The Tier 1 Finnish Tax Firm in 2018 & 2017 | The Finnish Transfer Pricing Firm of the Year in 2017, 2015 & 2011 | The European Tax Technology Firm of the Year in 2017*