Choosing the Right Transfer Pricing Method

March 2022

Exactera

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Let's say IKEA Distribution Services in the U.S. sells bookcases to a related-party retailer in France, IKEA Retailer France. Aside from moving bookcases, IKEA Distribution Services U.S. has another important job: It must price each bookcase appropriately.

Welcome to the world of transfer pricing, where goods and services sold between related parties must be priced the same way they would be between unrelated parties. In other words, related-party pricing must meet the arm's-length standard.

Transactions involving tangible goods, like IKEA's bookcases or Starbuck's coffee beans or Toyota's automobiles or Nike's sneakers, are common transfer pricing transactions. Every entity in a multinational company that engages in the intercompany sales or purchases of goods and services must prove it has priced those goods at arm's length.

And while the concept is simple enough, the world of transfer pricing has blossomed into a complex web of rules and uncertainty.

Profits related to transfer pricing directly impact taxable income in a given jurisdiction, and when you're dealing with cross-border transfer prices, each jurisdiction believes it is entitled to the most profits and, therefore, the most tax dollars.

Jurisdictions have their own country-specific demands in terms of transfer pricing documentation, sticking taxpayers with the burden of not only keeping up with unique and changing regulations, but also adhering to them.

Tax authorities are aware of the compliance minefield they've created, and they're taking advantage of it. In the past few years, many have increased the number of transfer pricing examiners on staff, the number of audits conducted, and certainly the amount of revenue gained from transfer pricing adjustments.

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Scrutiny is on the rise everywhere and taxpayers must know how to swim in a sea of uncertainty. Even the courts treat similar transfer pricing cases differently—letting one taxpayer go, issuing adjustments for another in a seemingly identical situation.

It's no wonder the transfer pricing landscape is intimidating for taxpayers. Comparability can be subjective, which gives tax authorities a lot of leeway. Proving arm's length prices depends upon, among other things, the economic analysis—and that analysis rides on choosing the most appropriate transfer pricing method.

Incidentally, transfer pricing methodology is becoming one of the most commonly challenged parts of transfer pricing transactions and a different method can lead to different results. How should taxpayers address selecting an "appropriate" transfer pricing method? Here's what you need to know.

The Most Appropriate Method

The secret to proving arm's length pricing? Choosing the right transfer pricing method. So, before computing a single calculation, ensuring a transfer pricing method is organic to the transaction is key. There are five OECD-approved methods, and each can yield a different result.

Let me emphasize that: Each method can deliver a unique arm's-length range. The wrong method is sure to throw off your analysis, your pricing—and your good standing with tax authorities.

In our increasingly aggressive transfer pricing landscape, tax authorities are paying more attention to transfer pricing methods than ever before. In fact, today, they are one of the most commonly challenged areas of transfer pricing documentation.

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Tax authorities in Australia, China, Mexico, Saudi Arabia, Argentina, the UK, and the U.S., along with many other countries, have openly cautioned that they will scrutinize—and likely challenge—transfer pricing methods.

Companies including Adecco, Cameco, and yes, IKEA have found themselves victims of those challenges, and engaged in expensive squabbles with authorities over whether a method was, in fact, the most appropriate.

As with any transfer pricing transaction, remember the subtext: For multinational companies, transfer pricing transactions might be the backbone of a legitimate multinational business, but to tax authorities, transfer pricing is a sly maneuver to shift profits out of high-tax jurisdictions into low- or no-tax countries.

Given that countries can only tax corporations on profits—tax authorities want to make sure profits land in their own countries, because then revenue will be sure to follow. For multinational companies, that means determining indisputable arm's-length transfer prices—and that begins with applying the best, or most organic, transfer pricing method for each individual transaction.

Unlike other areas of tax, transfer pricing has many subjective components, and transfer pricing methodology is an excellent example of this. Both OECD guidance and the United States' transfer pricing regulations, in Section 482, state that taxpayers should choose the most appropriate method.

Technically, the U.S. calls it the "best method rule," but it's essentially the same premise. However, if what's appropriate to taxpayers isn't deemed appropriate by tax authorities, then the discrepancy will create problems.

Before beginning an analysis, taxpayers are asked to explain why the selected method is most appropriate, and why the rejected methods didn't make the cut. While this can seem like an additional compliance burden, it's actually an opportunity for taxpayers to win over tax authorities. Here, taxpayers can explain their thinking and help tax authorities understand transactions from the perspective of the business.

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According to U.S. transfer pricing regulations, there are four factors to consider when selecting a method. First, think of the degree of comparability between the controlled transaction and the uncontrolled transaction. How comparable are they? What are strengths and the weaknesses in the comparison? Do the strengths outweigh the weaknesses?

Next, consider how much data is available. This is extremely important as third-party information can be hard to obtain and certain methods are only reliable if third-party data is included in the analysis. A lack of data might make one method more preferable than another.

If the data is available, how reliable is it? Is it based on facts or on forecasts? How many adjustments are needed to align the comparable companies?

Often, in an economic analysis, assumptions about the business have to be made. However, too many assumptions—or the wrong ones—can impact your analysis. So, U.S. regulations mandate that you evaluate the assumptions you'd have to make to use a specific method. Strong comparability is based on facts and circumstances, not hypotheses. So, the fewer assumptions, the better.

Lastly, how do data deficiencies affect your results? If the arm's-length range greatly varies based on assumptions or unavailable data, then you may want to consider a method with more flexibility.

The OECD's thinking falls along those same lines. The organization's guidance recommends considering the strengths and weaknesses of each method in the context of a given transaction.

According to the OECD, taxpayers should also consider the nature of the controlled transaction, which is determined by performing a functional analysis.

For example, in terms of IKEA's bookcases, an arrangement involving tangible goods, is the transaction based on a manufacturing function? A distribution function? Lastly, like the U.S., OECD guidance advises considering the availability and reliability of information of third-party comparables.

Four factors to consider when determining the most appropriate method:

- Degree of comparability
- Available data
- Too many assumptions
- Do data deficiencies affect your results?

Traditional Methods vs Profit-based Methods

There are two types of transfer pricing methods: Transactional methods and profit-based methods. Before the "most appropriate rule," the OECD recommended "the hierarchy of methods." Under the hierarchy, transactional methods received top billing and profit-based methods were seen as a last resort.

In the 2010 OECD Guidelines, the OECD abolished the hierarchy in favor of the most appropriate method. This opened the door to the profit-based methods, which are now commonly used, as well.

While both types of methods are now acceptable, and many tax administrations officially subscribe to the most appropriate method rule, many still have their own unofficial preferences.

France, for example, prefers the transactional net margin method. China prefers any method besides the transactional net margin method when intangibles are involved. Belgium prefers transactional methods to profit methods. But these are not official requirements. Still, it's always advantageous to taxpayers to consider those preferred methods—and when possible, to implement them.

If you can't, be sure to offer tax authorities a sound explanation in your documentation as to why their preferred methods are not applicable in the context of a specific transaction.

Transactional Methods: The CUP Method

The Comparable Uncontrolled Price Method, or the CUP method, as it's known, is often preferred by tax authorities around the globe. The Czech Republic, the Netherlands, Canada, and Mexico, among other countries, all prefer the CUP method, though they officially adhere to the most appropriate method.

There's a reason why tax authorities are fond of this method: It's straightforward and it's reliable. The CUP method compares the price for tangible goods bought and sold in a controlled transaction to prices for the same or similar goods bought and sold in an uncontrolled transaction.

We've talked about some of the challenges that data can present—third-party information isn't always public information, so it may not be available. The information that is available may not be reliable. The challenge with the CUP method is that it requires reliable third-party information to work.

CUP transactions must meet the highest comparability standards to offer a strong arm's-length result, and taxpayers often shy away from this method for that reason.

Taxpayers, however, should not be so quick to give up on this method, especially since they are repeatedly in the position to solve their own problem—often, without knowing it. The work-around is to use an internal CUP.

In the case of our IKEA bookcases, we'd see if the controlled party, IKEA Distribution Services U.S., has sold bookcases to third-party retailers. Let's say it has, and the price was $10 a bookcase.

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If IKEA Distribution Services U.S. has priced the bookcases it's selling to IKEA Retailer France at $10 a bookcase, then from this internal CUP, we know the price meets the arm's-length standard.

Internal CUPs serve taxpayers and tax administrations well because they accurately represent third-party transactions, and the data is reliable. This means they can prove indisputable arm's-length pricing easily.

Now, if IKEA Distribution Services had not sold to third parties, then we'd need to find an external CUP, a third-party distributor that sells a similar product to a related-party retailer. If those prices are aligned, then we know the pricing is at arm's length. If they're not, then the taxpayer may want to adjust its transfer prices before the tax authorities do.

Comparable Uncontrolled Price Method or CUP Method:

- Straightforward comparison of the sale of one product or similar products
- Favorite among tax authorities
- Challenging to taxpayers because of high comparability needs and often, a lack of available data
- Use of internal CUPs is always recommended when possible

Transactional Methods: The Resale Price Method

The resale price method is another transactional method. It's a preferred method for distributors, because it's less dependent on strict product comparability and more focused on comparability of functions performed and risks assumed.

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The method is best used on distributors who buy finished goods from a related party and resell them to third parties without adding additional value to the merchandise before it gets to the end customers. The resale price method compares the resale gross margin earned by the related party with the resale gross margin earned by comparable uncontrolled parties.

So, let's go back to IKEA. If IKEA Distribution Services U.S. sells a bookcase to IKEA Retailer France for $9 and IKEA Retailer France resells the bookcase—again, without materially altering the condition of the bookcase—to a customer for $12, the resale gross margin is 25%.

Now, we'd take that transaction and compare it to a third party with a similar function-and-risk profile, and if that third party company, say, Global Joe's Furniture Retailer, buys bookcases from a distributor and then resells them to customers for a 25% gross margin, we have an arm's-length price.

What's interesting here is that it doesn't matter what the actual price of the bookcase is—if IKEA Retailer France buys a bookcase for $9 and sells it for $12 and Global Joe's Furniture Retailer buys a bookcase from a distributor for $500 and sells it to customers for $625, both have a resale gross margin of 25%. Therefore, despite the extreme difference in the dollar amounts, the pricing is arm's length.

The Resale Price Method

- Great option for transactions involving distributors and resellers
- Compares the resale gross margin on controlled and uncontrolled transactions
- Challenging to identify reliable comparable uncontrolled transactions
- Material differences in accounting practices can affect the gross margins of independent comparable companies
- Resale price method isn't used all that often

Transactional Methods: Cost-plus Method

The cost-plus method, our last transactional method, compares gross profits to the overall cost of sales with those of independent companies. The cost-plus method is often applied in related-party transactions that involve manufacturing, assembling, and the production of tangible goods, because it's necessary to have discernable costs.

Using the cost-plus method, the question comes down to, "what is the markup I'm earning as the manufacturer?" So, if IKEA Manufacturer Argentina has costs of $130 per bookcase and sells them to IKEA Distribution Services U.S. at a markup of 25%, then we'd look at third-party manufacturers and distributors to see if their markups align. If the third-party markup over costs is also 25%, then we know we have an arm's-length range.

Now, as with the resale price method, the dollar amounts here do not matter. Comparability is based solely on the gross profit margin. If that markup is the same as what a third party would earn in a comparable situation then we are operating within the arm's-length range.

Evaluating costs, however, is never as easy as it sounds, and that's the problem this method raises: Companies itemize costs differently in their line items. One company might consider a cost under cost of goods sold, but another company might record that same item under operating expenses.

Discrepancies like that could throw off—or, at the very least, weaken—an analysis. That's precisely why the cost-plus method is most often used on transactions where costs can be easily determined, like transactions involving manufacturing.

Cost-plus Method

- Similar to the resale price method
- Compares gross profits to costs as opposed to the resale price
- High comparability standard
- The cost-plus method is used most often in transactions involving manufacturing, where costs are easily determined

Profit-based Methods: The Profit-split Method

Tax authorities love the profit-split method and yet taxpayers shy away from it. And that should raise a red flag. Generally speaking, there's only one reason a tax authority would love a transfer pricing method: Because they stand to profit from it. And that's the case with the profit-split method, a method that's used to divide profits between entities based on the value of their contributions.

Sounds simple, right? Well, wait. If you have three related parties in an intercompany transaction and one is in the U.S., one is in India, and one is in Australia, how do you convince the IRS and the Australian tax authorities that more profits—and therefore more tax revenue—should reside in India? Guaranteed, if one country is getting more, then the other jurisdictions involved will want more, too. And therein lies the issue with the profit-split method. For taxpayers, it's asking for inquiry.

The profit-split method comes in handy when comparables are hard to find—say, with unique and valuable intangibles. This is why it isn't used very often to analyze tangible goods, when comparables usually exist. Given the high level of subjectivity surrounding this method, it often gains the attention of tax authorities.

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Profit-based Methods

- Used to divide profits between entities based on the value of their contributions
- Good for when comparables are hard to find, say, with unique and valuable intangibles
- High level of subjectivity surrounding this method, it often gains the attention of tax authorities

Profit-based Methods: Comparable Profits / Transactional Net Margin Method

The transactional net margin method, known as the comparable profits method in the U.S., is the most commonly used method in transfer pricing. Its relaxed level of comparability makes it easy to adapt to various types of transactions, including tangible goods.

How does it work? It compares the net margin between controlled transactions and comparable uncontrolled transactions. There is a lot of leeway with the TNMM, as it's frequently called, and that's why it's so popular.

This method depends on net-profit data, which is often publicly available. Another plus: The TNMM is less sensitive to minor differences between comparable transactions. Also, the net profit margin can be computed with reference to cost, sales, or any other relevant profit level indicator, such as operating margin—a common use for transactions involving distributors.

This method offers a broad level of comparability and a high level of functional comparability. So, back to IKEA Distribution Services U.S. If IKEA has an operating profit of $24 and revenue of $144, that means the operating margin is 17%. If a 17% operating margin is in the range of our comparable companies' operating margins, then we are within the arm's-length range.

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TNMM:

- Option for distributors when you don't have apples-to-apples comparisons in the resale price or cost-plus methods
- Not influenced by accounting methods—total expenses are far less vulnerable
- Often used as a supplemental analysis—an analysis used to validate the merit of another

The Wrap

Intercompany transactions often involve tangible goods, and multinational companies must not only price those goods at arm's length, but they must also be able to prove they've priced those goods at arm's length. The key to doing so begins with understanding and choosing the right transfer pricing method—in other words, the one that is most appropriate for each individual transaction.

The OECD recommends five transfer pricing methods, and each one may deliver a different arm's-length range for the same transaction. So, using the most appropriate one—and proving it's the most appropriate—is critical to a successful analysis.

Tax authorities are more educated about transfer pricing than ever before, and given the subjectivity surrounding transfer pricing methods, they've become one of the most challenged parts of transfer pricing documentation. More often than not, if they're challenged, adjustments are sure to follow.

So, always look at the data you have—and the data you wish you had—and make a sound choice about your transfer pricing method. Explain the selection in detail in your documentation and perform your analysis based on facts and circumstances.

Tax authorities may be looking for base erosion and profit shifting, but an informed approach—and application—of transfer pricing methods minimizes the chance of finding it.

Turn Tax Data into Business Intelligence

At Exactera, we believe that tax compliance is more than just obligatory documentation. Approached strategically, compliance can be an ongoing tool that reveals valuable insights about a business' performance. Our AI-driven transfer pricing software, revolutionary income tax provision solution, and R&D tax credit services empower tax professionals to go beyond mere data gathering and number crunching. Our analytics home in on how a company's tax position impacts the bottom line. Tax departments that embrace our technology become a value-add part of the business. At Exactera, we turn tax data into business intelligence. Unleash the power of compliance. See how at exactera.com.