Riksrevisjonen

Office of the Auditor General of Norway

Transfer Pricing – or Transfer Mispricing

Background

- The role of multinational enterprises (MNEs) in the world has increased dramatically over the last 20 years
  - A global economy
  - New economies evolving: skilled labour, low production costs
  - Technological progress – communications, transportation, e-commerce/web business
  - Highly integrated business between countries, activities can be placed almost anywhere

- More than 30 % of world trade is intercompany transactions!

- Transfer prices are necessary in order to measure the true economic performance of the different companies within a MNE as these are separate profit centres

- Ordinary market forces may be put away when setting prices in MNEs
  - Prices often based on tax effects, seeking to reduce overall taxation of the group
  - Transfer prices can even be set at a level which cancels out the total tax which has to be paid by the MNEs

- Profit shifting through TP is legal until governments legislate to prevent it
- Perceived responsibility of MNEs: increase profits as much as possible while staying within the rules
- Not in line with the social, economic and political considerations of host countries?

Transfer pricing - Definition

- Wikipedia: **Transfer Pricing (TP)** is a profit allocation method used to attribute a multinational corporation’s net profit (or loss) before tax among the countries where it does business
  - Controlled transactions
  - Not necessarily only between countries
  - The term “MNE” also covers smaller companies
  - May be used to allocate profits to tax regimes with low tax rates and costs to regimes with high rates → TP is significant for both tax payers and tax administrations!
  - The term “Transfer Pricing” may refer to the setting, analysis, documentation, or adjustment of charges made between related parties for goods, services or use of property (including intangibles)
  - Perhaps one of the most controversial and least understood aspect of a multinational's operations?

Consequences

Complex taxation issues

- •Complex markets
- •Complex transactions
- •Complex legislation?

•Taxation rules cannot be viewed in isolation – issues must be solved in an international context

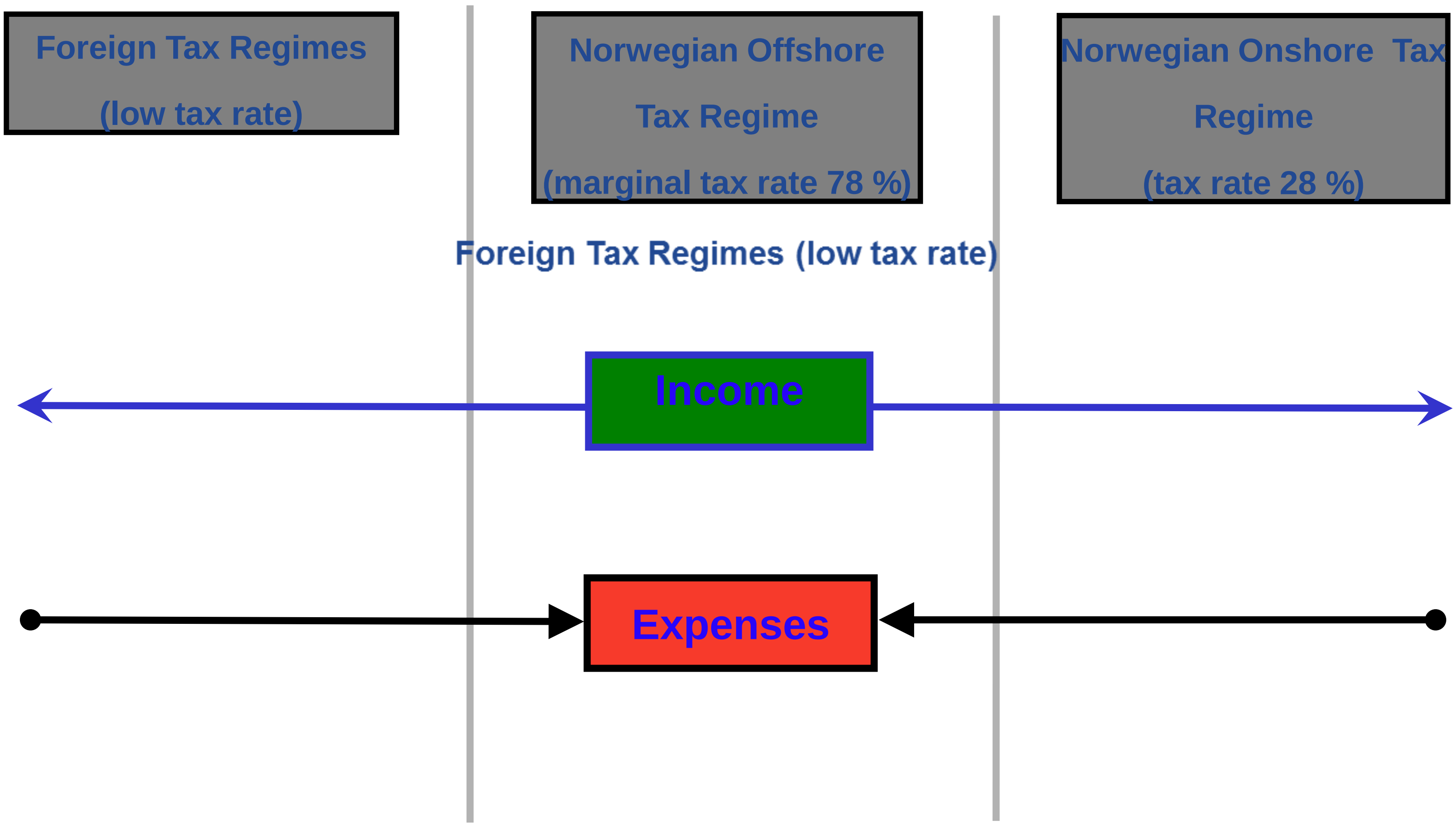
•Higher costs of compliance for the companies?

•Higher costs of control for the tax authorities?

•Risk of double taxation?

•(Profit opportunities for tax advisers and tax lawyers?)

Transfer Pricing – the Incentives



Common risk areas in Petroleum

- Intra group services (time writing)
- Funding (cash pools, loans, Single purpose vehicles)
- Purcahse and maitanance of assets (Rigs, drill heads, etc.)
- Intra group sales og crude and gas

Transfer Pricing – E&P Focus Areas

- Transfer Pricing is relevant in all kinds of intercompany transactions
- Current TP focus areas within the E&P sector in Norway:
  - Petroleum Products: NGL and gas prices
  - Tariffs on processing
  - Insurance
  - Borrowing and funding (incl. thin capitalization)
  - Guarantees
  - Financial instruments
  - Intra-group services – administrative services including general overhead (IT, HR) and technical services
  - (Norm price for sales of crude oil – average market price – avoiding TP-issues)

- A never-ending story...
- Extensive practice
- TP issues have been, and will continue to be, a key area for Norwegian tax authorities

On the International Level...

- More than 100 countries have adopted transfer pricing rules
- Common features:
  - Related parties may set prices in any manner
  - Tax authorities are allowed to adjust those prices where the prices charged are outside an arm's length range
  - TP legislation in most countries are based on the “arm’s length principle”
  - Some sort of guidelines are generally provided for determining arm's length prices, and for how analysis should be conducted
  - Most countries allow use of multiple pricing methods, where such methods are appropriate and are supported by reliable data, to test related party prices
  - Most countries have an appeals process whereby a taxpayer may contest adjustments
  - Many countries impose penalties on corporations if the countries consider that they are being deprived of taxes on otherwise taxable profit
  - Most OECD countries have included documentation requirements in their Tax Assessment Acts
    - → For transactions between Uganda and these countries, such documentation should be available if requested.

Historical Development

- 1930s: TP adjustments became a feature of many tax systems
- 1979: Both the U.S. and the Organization for Economic Cooperation and Development (OECD, of which the U.S. and most major industrial countries are members) had some guidelines
- 1988: UN report on “International Income Taxation and Developing Countries”
- 1994: guidelines ultimately became regulations in the USA
- 1995: OECD issued the first draft of current guidelines, which it expanded in 1996. The guidelines have been continuously developed since
- 2013: UN guidelines for developing countries
- A fluid marketplace – new approaches and techniques constantly evolved
- Growing focus on TP worldwide. Recent focus areas:
  - Profit-based methods
  - Comparability matters
  - Intangibles
  - Use of formulary apportionment – “Common Consolidated Corporate Tax Base”
  - Harmonizing TP documentation requirements
  - Improving TP dispute resolutions

The OECD Guidelines

- OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

- Intention: to help tax administrations (of both OECD member countries and non-member countries) and MNEs by indicating ways to find mutually satisfactory solutions to transfer pricing cases

  - Secures and protects an appropriate tax base in each jurisdiction
  - Provides a framework for analysing and solving TP issues
  - Enhance cross border trade on equal terms
  - Minimising conflicts between tax administrations – avoiding double taxation?
  - Minimising conflicts between tax administrations and MNEs – avoiding costly litigation?
  - Followed, in whole or in part, by many of its member countries in adopting rules, although it is non-binding
  - Some countries have adopted the guidelines almost unchanged, but terminology may vary across jurisdictions

OECD Guidelines – Table of Contents

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The OECD Guidelines – some Key Features

- Based on the arm's length principle
- The guidelines may be used by the tax authorities even where there is no intent to avoid or evade tax
- Multiple transactions may be tested aggregated or separately
- Testing may use multiple year data if relevant
- Tax authorities are to consider actual transactions between parties
- Adjustments are only allowed to actual transactions
- Transactions, whose economic substance differs materially from their form, may be restructured to follow the economic substance
- Transactions that differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner may be restructured

The Arm's Length Principle

- Transfer price: price charged between affiliated companies

- A transfer price may be a purely arbitrary figure, not connected to ordinary market conditions in any terms
  - Unrelated to costs incurred?
  - Unrelated to operations carried out?
  - Unrelated to risks undertaken?
  - Unrelated to added value?

- A transfer price is considered to be at arm's length if it is…
  - within a range of prices…
  - for comparable goods/services…
  - that would be charged by independent parties…
  - when sold on comparable terms…
  - in open markets.

- The OECD guidelines allows adjustments where prices or their effects are outside the arm's length range

Applying the Arm's Length Principle

- Be aware of the factors affecting the price – understand the controlled transactions

- The process typically involves the following steps:
  - Gathering information and documentation
  - Comparability analysis (characteristics, form/substance, functional analysis, contractual terms, market conditions, business strategies)
  - Transaction analysis
  - Evaluation of separate and combined transactions
  - Use of multiple year data
  - Use of an arm's length range
  - Recurring losses
  - Selection and use of transfer pricing methods

- A complex task – require goodwill from both the tax payer and the tax administration in terms of:
  - Documentation
  - Groundwork
  - Analysis
  - Research

Applying the Arm's Length Principle

5 major transfer pricing methods

Traditional transaction methods:

- Comparable Uncontrolled Price (CUP): compares the price charged in the controlled transaction with the price for comparable goods/services charged in an uncontrolled transaction
- Resale Price Method (RPM): the price charged by the reseller minus the reseller's costs and an appropriate profit in the light of functions performed and market conditions
- Cost Plus (C+, CP): adds the costs of the supplier and an appropriate profit in the light of functions performed and market conditions

- Profit-based methods:
    - The Transactional Net Margin Method/Comparable Profits Method (TNMM/CPM): compares the level of (net) profit that have resulted from controlled transactions with the (net) profit realised by a comparable independent enterprise. Working back from profit to price.
    - Profit-split Methods (PSM): takes the combined profits earned by two related parties and then divide it using a defined basis that is aimed at replicating the division of profits that would have been anticipated in an agreement made at arm's length. Working back from profit to price.

Applying the Arm's Length Principle

- No method is generally applicable to every possible situation
- All 5 methods have their own strengths and weaknesses
- All 5 methods are accepted by tax authorities
- All 5 methods imply some kind of comparison of prices, profits or margins
- Multiple methods <u>may</u> be use for a single transaction – not required by the arm's length principle
- OECD gives priority to transactional methods, described as the "most direct way" to establish comparability: any difference in prices can be traced directly to commercial and/or financial relations and arm's length conditions can be established by merely substituting the price → a closer relationship to the actual transaction
- Growing acceptance for profit-based methods – "best-method-rule"
- MNEs are free to use other methods
- How to choose the most appropriate method?
  - Experience
  - Functional analysis
  - Degree of comparability
  - Availability of reliable information

Difficulties in applying and implementing the arm’s length principle:

- Complex industry, complex markets and complex transactions
- Comparable transactions? How to make adjustments?
  - Lack of identical items
  - Lack of identical terms of sale
  - Market conditions vary geographically and over time
  - Bargaining power vary between parties involved
  - Some kinds of transactions will not be conducted between unaffiliated parties
- Does the taxpayer provide sufficient information and documentation? Are the taxpayer obliged to provide it? Confidentiality? Facts about the actual transactions are under the control of the taxpayer, no external data can be used…
- Use of “secret comparables” – limited disclosure to the tax payer?
- Some jurisdictions give preference to certain methods for testing prices
- Time limitations
- Use of intangibles
- Sophisticated financing arrangements
- The arm’s length price in not necessarily a specific price point, but rather a range of prices
- The taxpayers know that TP is difficult for the tax authorities

- **Transfer pricing is not an exact science!**

The Burden of Proof

- The tax administration bears the burden of proof in its own internal dealings with the taxpayer (e.g. assessment and appeals) and in litigation.
- The tax administrations must provide evidence that taxpayer's pricing is inconsistent with the arm's length principle.
- The tax administration might still oblige the taxpayer to produce its records to enable the tax administration to undertake its examination of the controlled transactions.
- The normal approach in most OECD countries.
- May be reversed in some countries under specific circumstances; for example:
  - if the taxpayer is found not to have acted in good faith
  - if the taxpayer is not cooperating or complying with reasonable documentation requests
  - if the taxpayer is filling false or misleading returns

The Risk of Double Taxation

- Each country involved in related party dealings can tax the amount of profit that is properly attributable to the economic contribution made in that country.
- International consensus: Consistent principle-based approaches through common accepted guidelines remove the risk of double taxation and thereby facilitate trade and investment.
- But is this the situation in real life…?

The Risk of Double Taxation

- International aspects are difficult to deal with
  - Involve two or more different tax jurisdictions
  - One country’s loss is the other country's gain – who should step aside?
  - Securing your own tax base: one country can be expected to want to legislate against unfair transfer pricing practices, while the other country can be expected to object to, and to resist, such legislation.
  - Any adjustment made implies a corresponding change
  - If no corresponding change is made, double taxation on parts of the tax payers profit will be the result →unilateral responses to multilateral problems?
  - Even if tax authorities agree on standards, principles and guidelines, they do not necessarily agree on the outcome on actual TP analysis carried out.

- Most tax treaties and many tax systems provide mechanisms for resolving potential double taxation, including negotiations between tax administrations. Within many systems, solutions may also be sought in advance.
  - MAP – Mutual Agreement Procedure
  - APA – Advance Pricing Agreement

Transfer Pricing Legislation in Norway

- The Petroleum Tax Act does not have any specific transfer pricing legislation
- However, there are some specific rules where transfer pricing is a key element
  - *The Norm Price System*
  - *Advanced Pricing Agreement (APA) for internal sale of gas*
  - *Information of gas sales*
- The Norwegian transfer pricing legislation is supplemented by the OECD transfer pricing guidelines
- The arm's length principle is the key principle
- Specific documentation requirements for internal transactions

Transfer Pricing

- The Norwegian Tax Act § 13-1
    - (1) Discretionary assessment may take place if the wealth or income of the taxpayer has been reduced as the result of a direct or indirect community of interest with another individual, company or entity.
    - (3) Wealth or income shall be assessed discretionarily as if there had been no community of interest.
    - (4) If there is a community of interest between enterprises resident in Norway and abroad, and their commercial or financial relations are subject to arms' length terms laid down in a tax treaty between the respective states, the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations adopted by the Organization for Economic Co-operation and Development (OECD) shall be taken into consideration for purposes of determining whether wealth or income has been reduced as stipulated in Sub-section 1 and for purposes of the discretionary assessment of wealth or income pursuant to Sub-section 3. These Guidelines should, to the extent applicable, be correspondingly taken into consideration in other cases than those mentioned above. The above shall only apply to the extent that Norway has acceded to the Guidelines, and provided that the Ministry has not decided otherwise.

Transfer Pricing in Developing Countries

- TP is especially daunting for smaller tax administrations
- Developing countries must provide a climate of political certainty and a environment for increased cross-border while at the same time not loosing out on tax revenues
- Detailed TP regulations are a must!
- Developing countries with weak tax administrations risk to absorb the effect of stronger enforcement and legislation in developed countries

- Smaller domestic markets and new sectors – few comparable transactions → PSM?
- Lack of complete and reliable information
- Use of targeted documentation requirement as an alternative to full-scale documentation?
- Employee turn-over? Lack of highly skilled employees?
- Lack of other resources? Databases?

Transfer Pricing - Insurance

- Use of captives within the E&P industry
- Complex and resource demanding area
- Lack of independent experts
- 2012: income additions amount to about mill. USD 34
  - Not final
  - May vary substantially from year to year

Background

- Law requirements:

- Different types of insurance coverage:
  - Physical damage (incl. removal of wreck, sue and labour)
  - Control of Well (incl. seepage and pollution)
  - Business interruption
  - Third party liabilities
  - War/terrorism
  - Cargo

- Insurance premiums are deductible operating expenses for the oil companies (78 % tax)

- Insurance often carried out by related companies (captives) in low tax countries, e.g. Bermuda (0 % tax)

Three Important Issues

- The “captive issue”:
- To qualify for a tax deduction, the insurer must take over risks on behalf of the insured on the conditions agreed upon between the parties. Whether risk shifting exists depends on a technical (legal) aspect as well as a material (economic) aspect.
- Are the risks de facto transferred in the policy at hand?
- Does the captive have sufficient financial funds to cover potential claims?

- The “transfer pricing issue”:
- If the captive in this respect is an insurance company for tax purposes, the next question is: how should the arm’s length premium rate be established?
- Norwegian tax authorities: focus on premiums for physical damage insurance

- The “indemnity issue”:
- Does the company receive the indemnities they are entitled to?

The Transfer Pricing Issue

- What is the arm's length premium rate?

- Choosing the right pricing method – basis of comparison:
  - Companies: what would this policy cost if bought in the direct insurance market?
  - Tax authorities: what would the price for this policy have been if the parties had been independent?

- Same conclusion? The crucial part is the adjustments!

The Industry's Suggested Pricing – Comparable Uncontrolled Price (CUP)

- How to establish a CUP?
  - Insurance carried out in the independent market by other companies
  - Expert/insurance brokers opinion
  - Quotes: The company asks at Lloyd’s for a non-binding offer. Same rate is used as the transfer price.
  - Quota Share: A small portion, for example 10 %, is placed in the market. The rest with the captive at the same terms.
  - Co-insurance: One policy is placed partly (2-5 %) with a recognised insurer (”leader”) and partly (95-98 %) with the captive (”co-insurer”).

- Why are these approaches problematic?

CUP – Practical Problems

- Few CUPs – most of the insurance policies are placed in captives
- Anonymous CUPs – also a problem for the tax authorities
- World-wide package policies – cross subsidizing? Lack of detailed premium schedules? Group benefits?
- Non-binding advices and offers – an acceptable CUP?
- Tailor-made policies – is the price set too high? Are risks priced the same way?
- Industry mutual – OIL. Conditions and premium methodology are different from the commercial energy insurance market.
- Long term insurance in captive insurance – favourable conditions?
- Conclusion: many major adjustments have to be made in order to achieve a useable CUP in this complex industry

The OTO's Suggested Pricing – the Cost Plus Method

- Basis: the captive's reinsurance costs for Norwegian risks
  - Captives are buying reinsurance in the direct energy marked
  - World-wide package: premium for Norwegian risks determined on the basis of gross assets

- Adjustments are made for:
  - Retained risk in the captive
  - Differences in limits and/or conditions

- Mark up for credit risk and administration costs

- Conclusion: technical exercise, but fewer and less complicated adjustments? Individual considerations must always be made when choosing the pricing method!

Court Rulings

- Several important issues have been discussed by the courts:
  - What is the correct basis of comparison?
  - Group benefits derived by the co-ordination of the placing of insurance's - where shall they be attributed?
  - Group benefits derived by the membership of OIL - where shall they be attributed?
  - Use of the cost plus method

- The Fina case: the Court of Appeal’s ruling of 18.02.2003:
  - The tax authorities considered the premiums which Fina Norway had paid to the group captive to be higher than the arm's length price
  - The captive reinsured most of it’s risks in OIL
  - The captive’s risk retention was limited and easy to define
  - The crucial disputed point: which pricing method should be used?

Court Rulings – the Fina Case

- The Court of Appeal (like the District Court) found that the cost-plus method, where one focused on the captive's costs for reinsurance etc., was the best suited method to establish an arm’s length premium in the Fina Case.

- The specific cost plus calculations indicated that Fina Norway’s insurance premiums were overpriced

Court Rulings – the Fina Case

- Group benefits: "When Fina (Norway) has chosen to insure in a captive and thereby co-ordinated its risks with other risks in the group in order to obtain lower insurance costs, parts of these reduced costs will have to be allocated to Fina's risks."

- It was not correct to ask what Fina (Norway) would have paid if the company had insured itself alone without co-ordinating its insurances with the other companies/subsidiaries in the group.

- OIL benefits: "It was not necessary to go through Brittany in order to buy the policy in OIL. It does not then seem reasonable that the whole benefit of the cheap insurance in OIL shall be attributed to Brittany."

- The benefit of OIL membership should be attributed the operating companies

- Conclusion: When establishing an arm's length premium one have to take into consideration the possibility for benefits of the captive's co-ordination of the subsidiaries' policies and also the benefit of captive's reinsurance in OIL.

Other relevant court rulings

- The Agip case – ruling of 11.10.2001 (Supreme Court)
  - What is a useable CUP?
  - No comparable market rates available – comparison made with (controlled) rates of companies participating at the same field.

- The Hydro case – ruling of 26.11.2007 (Court of Appeal)
  - OIL membership is an advantage which should be allocated the operating company.
  - The CUP method is not preferable in such cases as there are more major adjustments to be made compared to the cost plus method.

Transfer Pricing – Intangibles

- The OECDs definition of an intangible asset for transfer pricing purposes:
  - *... something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.*
  - literally meaning assets that cannot be touched (non-physical)
  - intellectual property, no legal definition
  - excluding financial assets

Different Types of Intangibles

- "Trade intangibles"
  - Know-how related to the production of goods and the provisions of services
  - Typically developed through R&D →patents, trade secrets, etc.
  - Licenses
  - General goodwill
  - Workforce
- "Marketing intangibles"
  - trade names & brands, trademarks, manifestations, client lists, market position, distribution channels etc.
  - aid in the commercial exploitation of a product or service
- Others?

Intangibles – some Key Features

- Returns often highly dependent on intangibles
- High rates of returns relative to other assets
    - Traditional industry: effective use of equipment and other tangible assets to cut costs and enhance their competitiveness
    - Today's industry: information technology and globalization has paved the way for businesses to create new markets using information, knowledge and other intangible assets
- Unique and highly valuable
- Controlled and owned – legal and/or economic rights – joint ownership
- Exclusivity
- Legal protection
- Ownership easily transferred
- Ownership often placed in low tax jurisdictions – related companies charged for their use
- Creates potential for valuable tax planning and profit maximisation

The Use of Intangibles

- A source of competitive advantage in commercial activities
  - impact on the ability of an entity to create value over and above what could be expected from the performance of basic functions

- Transactions involving intangibles constitute a rapidly growing proportion of an MNE's commercial transactions.
  - Have increased the complexities involved in analyzing and understanding such transactions.
  - Issues relating to intangibles are among the most challenging topics within TP → many disputes

- Dealings with intangibles can occur in many (often subtly different) ways:
  - License agreements involving royalty payments
  - Outright sale of intangibles
  - Compensation for intangibles included in the price of goods/services
  - "Package deals": combination of the above

- Transactions should be at arm's length!

Pricing/Valuation Methods

Different TP methods apply depending on the characteristics of the actual transaction

- What is bought/sold?
- What kinds of benefits are received?
- Be aware of the versatile nature of intangible assets
- General principles apply, but be careful in applying the OECD transfer pricing methods
- Which assumptions are underlying the chosen valuation model?
- Which components of the transaction relate to intangibles and which relate to the ordinary provision of goods/services? Could any components of the transaction be isolated?

CUP:

- Market based pricing
- Can be used where reliable comparable uncontrolled transactions can be identified.
- Typical transactions:
  - Transfer of rights: CUP may be used if there exists an internal comparable
  - Licensing: compensation through royalties → 3. party comparison might be available → CUP
- Particular consideration must be given to the comparability of the transactions:
  - Many (most?) intangibles are unique – are the intangibles comparable?
  - Intellectual property tends to relate to the uniqueness of a product rather than its similarity to other products

Pricing/Valuation Methods

- Profit Split Method (PSM)
  - Recommended when reliable CUPs are not available
  - Looks at investments, risks and returns to try to ascertain a reasonable division of profit
  - Income based valuation techniques can be useful tools when applying the PSM
    - Calculation of the discounted value of projected future income streams/cash flows attributable to the intangible being valued
    - Require assumptions on expected life and discounting rate

Important considerations when applying the PSM:

- The functions, assets and risks of the respective parties to the transaction
- The business reasons for engaging in the transaction
- The perspectives of and options realistically available to each of the parties to the transaction
- The competitive advantages conferred by the intangibles
- The expected future economic benefits from the transaction
- Other comparability factors: local markets, location savings, assembled workforce, group synergies, geographic scope, etc.

Pricing/Valuation Methods

- Cost Plus Method
  - A cost-based method involves capitalizing the costs incurred in generating the intangible asset and determining the appropriate factor to be recovered over its useful life
  - Is there any correlation between the cost of development and resulting profits?
  - Probably not suitable for intangibles, discouraged by OECD

- Transactional Net Margin Method (TNMM) and the Resale Price Method
  - "One sided": seek to price the appropriate return to one of the parties to a controlled transaction without necessarily any regard to the results of the other party
  - OECD: not reliable methods for directly valuing intangibles
  - Disentangling intangibles from a product's or an industrial process' other features: It is difficult to determine the value of other functions, risks, assets, etc. and thereby deriving a residual value for intangibles

Intangibles – OECD on TP issues

- *Transfer pricing outcomes in cases involving intangibles should reflect the functions performed, assets used and risks assumed by the parties. This suggests that neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE group to retain the benefits or returns with respect to intangibles without more."*

Difficulties in Applying the Arm's Length Principle

- Identification of transactions involving intangibles
  - Of the intangible itself
  - Of the price paid → uncertain value
  - Not necessarily recognized for accounting purposes

- Highly mobile: is income reported in the jurisdiction making economic contributions?
- How do expected future returns affect the value of intangibles?
- Joint ownership
- Documentation on the commercial basis of the transactions
- Value is not necessarily attributable to just one intangible
- Strong focus on legal rights, ignoring aspects like:
  - How the intangibles were created
  - Who directed and controlled the research and/or development
  - Enhancements
  - Maintenance and protection
  - Risks
  - Costs

Example – Location of Key Employees

- Key employees strategically manage the different phases of developing, maintaining and protecting the company's intangibles
- The company wishes to have a centralized intangibles ownership structure → key personnel must work in that central location
- What if these employees move or change and work in jurisdictions outside that location?

- Tax authorities may argue that they should tax a material part of the income generated from use of those assets (i.e. the key employees).

Example – Ownership Restructuring

- Company A is a profitable operating company
- Company A has both upstream (high tax) and downstream (ordinary tax) divisions
- Global intangibles are gathered together in company A
- Company A raises significant amounts of related party debt to acquire the intangibles
- All intangibles, including the intangibles of company A, are then transferred to company B
- Company B is located in a tax haven
- Company A pays royalties to company B
- The (future) development and maintenance of the intangibles are carried out by company C
- The costs of company C are allocated to operational companies like company A on the basis of different allocation keys

- With focus on company A, what kind of TP issues might arise in this context?

Example – Ownership Restructuring, ctnd

- Possible tax avoidance:
  - Company A suffers significant additional finance costs
  - Company A loses ownership of its own intangibles without proper compensation
  - Company A is required to pay a licence fee or royalty
  - Company A is required to pay for the future development and maintenance of the intangibles despite:
    - No legal or economic ownership in the intangibles
    - Annual payments of royalties
  - Company A pays a too high share of the costs that are to be allocated from company C
  - Company A allocate a too high share of the costs to its upstream business

Further Readings

- OECD Discussion Draft on Transfer Pricing Aspects of Intangibles
  - Identification of parties entitled to intangible related returns
  - Transactions involving the use or transfer of intangibles
  - Determining arm’s length conditions in cases involving intangibles
  - Available on the Internet

- OIL

Time Writing and transfer pricing

- Special considerations for intra-group services
- Two questions need to be answered
- Have intra-group services been rendered?
- Determining arm's length charge

Have intra-group services been rendered?

- Would an independent enterprise be willing to pay for the activity if performed by an independent enterprise?
- Shareholder activity and stewardship activity
- If the activity is found to be stewardship activity it is an intra group service

Determining arm's length Charge

The consideration needs to be done in each case, and the method used needs to be assessed in each case

- Three methods has traditionally been used to determine the arm's length price. CUP, cost-plus and TNMM
- CUP method is most appropriate where there is a comparable service provided to an independent enterprise (accounting, legal services, auditing etc.)
- Cost-plus method is most appropriate in the absence of a CUP and the nature of the activities involved, assets used and risks assumed are comparable to those undertaken by independent enterprises.

- Transactional profit methods may be used where they are the most appropriate to the circumstances of the case.

In exceptional cases (no CUP or Cost plus) it may be helpful to take account of more than one method. (OECD guidelines paragraph 2.11)

Calculating the arm's length consideration

- Matter should be considered from both the view of the provider and recipient in order to find an acceptable arm's length price
- The method used should be determined according to OECD guidelines Chapter I, II and III

Transactional profit methods

In general: Transactional profit methods examine the profits that arise from particular transactions among associated enterprises.

Profit arising from a controlled transaction can be a relevant indicator of whether the transaction was affected by conditions that differ from those that would have been made by independent enterprises in otherwise comparable circumstances

Two methods mentioned in the OECD guidelines:

- Transactional Net Margin Method (TNMM)
- Transactional Profit Split Method

Transactional Net Margin Method (TNMM)

The TNMM examines the net profite relative to an appropriate base (e.g. costs, sales assets etc.) that a taxpayer realises from a controlled transaction. Note that this method operates in a manner similar to the cost plus, and resale price methods. Thus, in order to be applied reliably the method must be applied in a manner consistent with the cost plus and resale price methods.

Common risks in Petroleum

- Intra-group services (Time writing)
- Funding (Cash pool, Loans)
- Cost Sharing Arangements
- Head quarter services (Marketing, Legal, Accounting)
- Intra group sales