Common misconceptions found in pragmatic policies

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Policies incorporating misconceptions run the of risk of deviating from the arm's length principle.

There are a wide variety of approaches used in transfer pricing policies to ensure compliance with the arm's length principle. The variety of transfer pricing policies arises due to the differing scope and responsibility transacting parties possess, availability of arm's length data, industry forces and business strategies. One other factor that influences the establishment of a transfer pricing policy is the materiality or magnitude of the transaction. In particular, companies with transactions that have low volumes or low materiality find unique ways of adhering to the arm's length principle and pursue highly pragmatic approaches for their transfer pricing policies.

Chapter one of the Organisation for Economic Co-Operation and Development Transfer Pricing Guidelines ("OECD Guidelines") recognises the importance of pragmatic solutions for certain transfer pricing policies. In particular, the OECD Guidelines state "it may be reasonable for a taxpayer to devote relatively less effort in finding information on comparables supporting less significant or less material controlled transactions."[1] In addition, paragraph 3.83 of the OECD Guidelines states:

> "Small to medium sized enterprises are entering into the area of transfer pricing and the number of cross-border transactions is ever increasing. Although the arm's length principle applies equally to small and medium sized enterprises and transactions, pragmatic solutions may be appropriate in order to make it possible to find a reasonable response to each transfer pricing case."

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Although more pragmatic approaches to address a company's transfer pricing policy are recognised by the OECD Guidelines, they are often based on commonly observed transfer pricing misconceptions. This may be a result of the lower resources invested in establishing transfer pricing policies that use limited or misconceived techniques. This article addresses some common misconceptions about certain transfer pricing techniques which although more commonly found in small and medium size enterprises, have also been found in the policies of larger MNEs.

Misconception One:

"I'm not overly concerned about my transfer pricing policy. If I'm wrong, Competent Authority could just deal with it then"

There is some element of truth in this, as well as other misconceptions addressed in this article – but only under specific circumstances and conditions. That is, the company in question may be correct in the sense that their risk is low and they can rely on Competent Authority to resolve their transfer pricing exposure. However, in that circumstance, several factors are raised, including:

- Is competent authority available? Do the companies that are party to the transactions reside in countries that possess a tax treaty? If there is a tax treaty and the treaty contains a Mutual Agreement Procedure, is it effective in relieving double-taxation?
- What is the exposure to interest expense relating to tax adjustments or transfer pricing-related penalties? Even though the transaction in question may not be considered material, what would be the magnitude of the reassessment for a penalty to be

incurred? What would the estimated interest expense be for such a transaction? Are penalties and expenses tax deductible in the country in question?

- Does one of the related parties have a loss position that can be used to offset an increase of income from the competent authority resolution?
- Are the relative rates of tax similar? That is, after the reduction of double tax, has the company's tax liability increased?
- Is there a potential foreign exchange loss? With the change of transaction price, the settlement payments from competent authority will likely be calculated at present exchange rates. Has the exchange rate changed so that a loss has occurred?
- How has a competent authority result changed future uncertainty? Typically, only the results of the competent authority negotiation have been communicated. The rationale for the negotiating is not a legal precedent for the company for future transactions. Uncertainty continues for taxation years after the competent authority resolution.
- Certain countries will require a payment for a portion of the taxes owing from the reassessment prior to competent authority resolution. This tying up of funds adds to the costs of the competent authority process.

Although tax treaties having a MAP can assist in reducing or eliminating double taxation, it is not safe to assume that the taxpayer's circumstances will result in Competent Authority providing full or partial relief from double taxation. There are also a number of other considerations, including the overall cost of competent authority, that challenge the misconception that the double tax treaty eliminates all expenses related to the transfer pricing exposure.

Misconception Two:

"I prepared transfer pricing documentation some years ago. Nothing has changed so I don't have to update it"

Under a unique set of circumstances, transfer pricing documentation from a prior year may be a pragmatic approach for small and medium sized enterprises to document their cross-border transactions. Factors that have to be considered under this strategy include:

- Is the transfer pricing policy dependent on a profit level indicator benchmark? Even though the facts and circumstances may not change materially from year to year for the company, can the same be said for all of the comparable companies in the benchmark? Are there industry or country factors that change the results of the benchmark results?
- For some small and medium businesses, the industry and business strategy does not change materially on a year-to-year basis. However, the accumulation of small changes over a series of years may impact the characterisation, strategies or business conditions of one or more of the entities involved in the transfer pricing policy. For instance, one entity may have the responsibility for global marketing, with some assistance from a foreign entity. Over time, this foreign entity may build this department, and eventually becomes responsible for the marketing, and the characterisation of the entities with respect to the marketing function has changed, over a series of years.

Light updates may be required annually for companies taking a pragmatic approach to transfer pricing compliance. However, several tax authorities expect a full update of the transfer pricing documentation, at minimum, every three years.

Misconception Three:

"The benchmark for my documentation is continent-specific. I don't really need country specific comparables"

Certain database sources have better coverage of certain countries, which is especially true for the United States. A comprehensive suite of sources for comparable companies that have extensive coverage of multiple countries is typically more expensive, and not practical for small or medium size enterprises. As a result, the scope for finding comparable companies for a benchmark typically is expanded outside of countries with limited resources available. This can cause problems for specific tax authorities that, in practice, have a strong preference for regional comparable companies.

In those circumstances, it is beneficial to document effort spent on seeking regional comparable companies. This may even take the form of focused internet searches to identify regional comparable companies. It has been observed that tax authorities are more accommodating of global benchmarks if a company demonstrates an initial effort has been performed for regional comparable companies, even if the results of these efforts identify few or no comparable companies. However, there are certain tax authorities that stipulate use of regional comparable companies. Another pragmatic approach is to develop a small set of the most comparable companies found, and to analyse the differences from that regional set to a global set that has a higher degree of functional comparability.

Misconception Four:

"You don't need to document routine administrative services"

This is a common misconception that since a service is routine, and no cost mark-up is applied, then no effort is required to document the transaction or to defend the charge to a tax authority. Unfortunately, management services, including routine administrative services, are one of the most closely scrutinised transactions by tax authorities, as they are one of the simpler transactions to audit. Because of the time-sensitive detail required to document the transaction, it often becomes problematic to recreate the information necessary to justify the charge under an audit by a tax authority. Companies often find themselves negotiating part of the charge to be reassessed, even though initial effort on documenting the service, benefit, and charge calculations at the time of transaction may have avoided this unnecessary reassessment.

Misconception Five:

"I've got a quote from a third party that I use as a CUP"

The converse to this misconception "A third party quote can never be used if the transaction did not occur" is also common. Depending on the nature of the third party quote, it may or not be used to benchmark a related party transaction.

The US regulations detail when a third party quote may be used:

> *1.482-3(b)(5)(i) In General*
> A comparable uncontrolled price may be derived from data from public exchanges or quotation media, but only if the following requirements are met:
> *1.482-3(b)(5)(i)(A)*
> The data is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled sales;
> *1.482-3(b)(5)(i)(B)*
> The data derived from public exchanges or quotation media is used to set prices in the controlled transaction in the same way it is used by uncontrolled taxpayers in the industry; and
> *1.482-3(b)(5)(i)(C)*
> The amount charged in the controlled transaction is adjusted to reflect differences in product quality and quantity, contractual terms, transportation costs, market conditions, risks borne, and other factors that affect the price that would be agreed to by uncontrolled taxpayers.
> *1.482-3(b)(5)(ii) Limitation*
> Use of data from public exchanges or quotation media may not be appropriate under extraordinary market conditions.

Support for use of the third party quote is limited as outlined in the US regulations above. Other tax jurisdictions may accept a third party quote under similar circumstances. However, often a third party quote used does not satisfy the above conditions and other supporting material is likely to be required.

Misconception Six:

"Profit Level Indicator benchmarking must be a single-year analysis"

When establishing a policy going forward, a multi-year average is advisable as the policy is based on following a forecast. This is often the case when establishing a policy within an Advance Pricing Agreement. When documenting the results and preparing annual documentation, a single year analysis may be more effective.

Some tax authorities, including Canada, have stated a strong preference for using single year results.[2] Multi-year analysis has been used when an economic cycle is clearly demonstrated and key for the analysis of the transfer pricing policy.

Ideally, if a multi-year and single year benchmarking demonstrate arm's length terms and conditions were followed, then it is best to use both to substantiate the transfer pricing policy.

Misconception Seven:

"A full range of results is not as good as the interquartile range"

Some countries specify an interquartile range or alternative defined range within the set of comparables used. Other countries that don't specify often use the interquartile range in practice. Documentation that addresses countries where one country specifies an interquartile range versus a full range may be tempted to relax to the full range if the results demonstrate the country that specifies the interquartile range is on the beneficiary. In these cases, a full range may not be accepted due to increased comparability standards practiced in countries that do not specify the interquartile range. That is, only a subset of companies or comparable transactions would be valid for that particular country, whereas countries that use the interquartile range are more accepting of less than comparable companies due to the fact the interquartile range would address these outliers.

In summary, misconceptions on transfer pricing may impact the transfer pricing policies followed under a pragmatic approach. Transfer pricing policies that incorporate one or more of these misconceptions are at risk of deviating from the arm's length principle.

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[1] Organisation For Economic Co-operation and Development, Transfer Pricing Guidelines, Paragraph 3.82

[2] "Transfer Pricing: Acceptable Arm's-Length Prices Within the Range", Ronald Simkover, Canadian Tax Foundation in Report of Proceedings of the Fifty-Fourth Tax Conference, 2002 Conference Report

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