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Oliver Treidler

Transfer Pricing in One Lesson

A Practical Guide to Applying the Arm's Length Principle in Intercompany Transactions

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Foreword

Transfer Pricing in One Lesson, according to its author Oliver Treidler, is designed as a pragmatic survival kit—not a "magic bullet"—for handling the day-to-day challenges facing a transfer pricing (TP) professional. While the book is a practical guide aimed at young TP professionals working in consulting or industry who have been asked to apply the OECD's post-BEPS Transfer Pricing Guidelines, I suspect all TP professionals will find the book useful reading. I've been studying transfer pricing for 45 years and still find *Transfer Pricing in One Lesson* helpful reading, so I suspect others will also.

Treidler argues that to be successful as a TP professional one must understand the arm's length principle and how to apply it to specific situations. The book starts with "one key lesson" (the basics of transfer pricing), which is then applied to a variety of specific situations. To illustrate the cases and provide a real-world feel for the lesson, Treidler creates a fictitious multinational (MNE), the Prima Group, and explores how the lesson can be applied in different situations.

The core message in the book is that transfer pricing is an art, not a science, where "the art of transfer pricing consists in never losing sight of the reality of a specific business when applying the arm's length principle." Treidler recognizes that there are both business and tax considerations that affect transfer pricing choices, and he is mindful that the TP professional must find an "appropriate balance" between these pressures. To be successful at finding this appropriate balance, he argues that "you have to avoid the myopia of a fragmented transaction-by-transaction type of analysis and always be mindful of the economic essence of the business relationship as a whole."

To do this, the TP professional must align the firm's transfer pricing structure with the firm's business model. Treidler says, "the first and foremost task of a transfer pricing consultant is therefore to understand the business model of his client and ensure that the model is accurately translated into a tax viable transfer pricing structure."

Treidler argues that successful alignment depends on two tools or processes that can be used to translate the firm's business into an analytical framework that can be used for tax purposes. These two processes are:

- Establishing an adequate level of segmentation of the firm's transactions
- Performing a value chain analysis for each identified transaction or group of transactions

The first process—segmenting the business into transactions—builds on industry analyses such as Porter's five forces model to identify the "commercial relations" and the "conditions and economically relevant circumstances" between the related parties. Such identification, of course, is required as part of a comparability analysis under the OECD's Transfer Pricing Guidelines.

The second process, also required by the Transfer Pricing Guidelines, is value chain analysis (which he refers to as a functional and risk (F&R) analysis). Treidler views value chain analysis as the "heart and soul of transfer pricing." Each entity in the MNE group must be identified in a general way, based on its functional and risk profiles, as either a low-risk, low-return (routine) entity or a high-risk, high-return (entrepreneurial) entity. The routine entity should receive a routine (arm's length) return in line with its routine functions and risks. The appropriate amount can be determined by treating the routine entity as the tested party and using a one-sided transfer pricing method to determine its arm's length return. The entrepreneurial entity is then compensated with the residual return after the routine entity or entities have received their return.

The functional and risk analysis forces the TP professional to "dissect the business model of the MNE." With that model, the TP professional can identify which entity should be the tested party and come to a high-level understanding of what an arm's length allocation of profits should be to that entity. Treidler argues that amount should intuitively be appropriate from both business and tax perspectives.

With the basic lesson in place, Treidler then moves to applying the lesson to the types of transactions that are likely to face a young TP professional. Each situation is illustrated with the Prima Group case. As one might expect, he starts with CUP, the comparable uncontrolled price, and then moves through the basic methods. I summarize some of the insights here:

- CUP: Comparing "Like with like" is not a trivial task.
- Resale Price Method: Comparability doesn't stop at the gross margin.
- TNMM: Arm's length net margins should make everyone happy.
- Profit Split Method: Internal negotiations are useful for approximating an arm's length allocation of profits within the MNE provided that entities engage in real negotiations.
- (Net) Cost Plus Method: Arm's length net margins should make everyone happy.

The book goes on to apply the lesson to more complex transactions, in particular to transfer pricing of management services and financial transactions. Lastly, Treidler discusses the critical importance of properly prepared documentation for the tax authorities.

Three annexes end the book. They are: (1) a Transfer Pricing Basics Questionnaire, (2) a Checklist for Benchmarking Studies, and (3) an Application of a CUP License Fee. In addition, three Excel-based tools are available in a supplementary online package: (1) Value Chain Analysis Tool, (2) Cost Allocation Tool, and (3) Cash Pool Tool. TP professionals, especially those new to the field, will find the annexes very helpful.

Treidler has several years of experience as a transfer pricing practitioner, first for Big Four firms and later in his own consulting practice where he also offers workshops on transfer pricing and value chain analysis. The book is written in a practical and captivating style—as if the author were talking directly to the reader—which should give it a broad appeal, not only to beginning TP professionals but to those who are further along in their careers also.

It's clear from reading this book that the author is passionate about transfer pricing. He believes—as do I—that the arm's length standard is the best way to value related party transactions within the MNE group, best not only for tax purposes but also because—when properly done—the arm's length standard best captures the realities of the MNE's activities.

Can transfer pricing be taught in one lesson? I believe that yes it can—and Treidler shows us how it can be done. I enjoyed reading this book and believe you will do so also. Enjoy!

Texas A&M University, TX, USA Lorraine Eden
May 5, 2019

Contents

About the Author

Oliver Treidler is CEO and founder of TP&C GmbH based in Berlin. TP&C is an independent provider of consulting services, including sub-contracting services, for projects focused on transfer pricing and controlling. The consulting philosophy of TP&C, which is also the leitmotiv of *Transfer Pricing in One Lesson*, is deeply rooted in a business perspective on transfer pricing—i.e., "talking business not legalese."

Prior to founding TP&C, Oliver worked as a senior manager in the transfer pricing department of a top 10 auditing and consulting firm in Berlin. He learned the ropes of transfer pricing while working for two of the Big Four in Frankfurt and Hamburg.

Oliver frequently publishes on transfer pricing issues and actively contributed to various public discussion procedures of the OECD BEPS project. He holds a master's degree in international economics and European studies from the Corvinus University of Budapest (M.Sc.) and a Ph.D. in economics from the University of Würzburg.

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Chapter 1
Introduction

The title of the book is intended as a homage to Henry Hazlitt, whose timeless masterpiece "*Economics in One Lesson*" has been such a wonderful and inspirational book to many economists—at least those sympathizing with the Austrian School of economics.

This book on transfer pricing contains a healthy dose of economics as well as general aspects from the field of international business. Like Hazlitt's book, *Transfer Pricing in One Lesson* is primarily written for the "beginner" in this highly specialized field, including students interested in subjects such as law, economics, business, or politics. Most importantly, I hope that (young) transfer pricing practitioners and employees in tax or accounting departments will find helpful guidance in this book. I am relentless in teaching the lessons to my own employees and my intention is twofold; first, I want to provide them with a frame of reference that will be useful throughout their future careers as transfer pricing consultants; second, I want them to enjoy transfer pricing.

While working and learning during actual projects is always good, it is sometimes hard for young professionals to see the "big picture"; i.e., when your first assignment is to participate in a complex project focused on analyzing a cash pool of a large MNE and your second assignment is to contribute on a loan benchmark for another large MNE, chances are that you will have a hard time to take a breath and think about the nature and beauty of the profession you have (presumably) stumbled into. Well, take a breath (drink some coffee) and take some time to learn about the basics of transfer pricing; i.e., learn about the arm's length principle. My advice to you is: spend time on the basics early in your career; you will have to specialize soon enough. This book should allow you to learn in your own time and at your own speed (will not show up on your time card) and you may even want to use it as a conversation starter with one of your more experienced colleagues.

Just as reading Ludwig van Mises's "*Human Action*," regardless of the unquestioned greatness of the book, is likely to be "overkill" for those beginning to grapple with the subject of economics, the transfer pricing tomes written by leading figures in the field such as Alexander Vögele as well as the countless

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OECD Publications are simply overwhelming for those with a professional life outside of transfer pricing. Thus, the structure of this book is designed to provide the reader with **one key lesson** and to subsequently apply this lesson to a host of specific examples. The examples will be provided within "case study" subsections, which will introduce you to a fictitious MNE, the "Prima Group," navigating through day-to-day transfer pricing challenges that may be familiar to you. The aim is to equip you with a pragmatic "survival kit" for your day-to-day transfer pricing challenges. In other words, this book is not designed to mutate into some sort of "chic" reference that can be cited in tax memos but rather intended to serve you as a guidebook—helping you never to lose your orientation, even when confronted with more intricate transfer pricing issues.

The core message of *Economics in One Lessons* can be summarized as

> the art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups (H. Hazlitt)

The core message of *Transfer Pricing in One Lesson* can suitably be summarized as ***the art of transfer pricing consists in never losing sight of the reality of a specific business when applying the arm's length principle; to find an appropriate balance between the business and the tax considerations, you have to avoid the myopia of a fragmented transaction-by-transaction type of analysis and instead always be mindful of the economic essence of the business relationship as a whole***.

Somewhat opposed to Hazlitt, I do not intend to focus on unmasking fallacies in the economic reasoning of others but rather provide the reader with references to expertise from people who I have encountered in my professional life as a transfer pricing consultant and to whom, in my opinion, it is worthwhile to listen. I have tried to write this book as simply and with as much freedom from technicalities as is consistent with reasonable accuracy. Due to the opacity of the subject, this book can be no more than a starting point for your further studies and I sincerely hope that it may motivate you to embark on that journey.

Lastly, I am painfully aware that many employees in tax or accounting departments that are being forced to cope with transfer pricing regard this assignment as either boring or dreadful, especially when dealing with tax lawyers or tax advisors, who, not entirely without cause, are prone to emphasize the myriad of risks involved in transfer pricing. Well, again, this book is designed as a "survival kit" (not a magic bullet). Gaining an improved understanding of the arm's length principle will bring you a long way toward minimizing transfer pricing-related tax risks (not eliminating them). To effectively cope with transfer pricing challenges, think about business and economics first and about tax law second. To achieve a sustainable transfer pricing system, it is much more important to have a solid understanding about your business than to have expert knowledge of idiosyncratic laws and regulations. This is especially true, as transfer pricing practitioners will have to cope with a truckload of differing national regulations, while the definition of the arm's length principle is luckily (largely) the same around the globe.

So, in other words, borrowed from another beloved Guidebook, "*Don't Panic*."

Chapter 2
The Lesson

To successfully deal with transfer pricing issues, you will have to understand the arm's length principle and learn how to apply it to your specific situation. It is that simple—at least for as long as all nations continue to fundamentally base their regulations on the arm's length paradigm. Because each individual group member of an MNE is subject to tax on the income arising to it (so-called "separate entity approach"),[1] the attention of tax authorities is naturally focused on the nature of the transactions between these individual members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions. Such an analysis of the controlled and uncontrolled transactions, which is referred to as a "comparability analysis," is at the heart of the application of the arm's length principle.[2]

Now, what is the essence of the arm's length principle? Well, pursuant to the arm's length principle, MNEs are required to price their intercompany transactions by utilizing prices that are (or would be) agreed between unrelated third parties in comparable circumstances. By basing the pricing of intercompany transactions on such a reference, i.e., (hypothetical) market prices, the artificial shifting of profits between companies of MNE located in different jurisdictions ought to be prevented. Again, this sounds rather straightforward but not quite so fast.

It is often not easy to identify market prices that can be used as an appropriate reference. Thinking about how complex the issue of "value and pricing" is and seeing how these concepts evolved throughout history, i.e., from the "labor theory of value" to the "subjective-utility value theory," it should hardly be a surprising statement that "there is no one 'true', 'correct' or 'universal' price for a good or a

[1]See OECD (2017a), Paragraph, 1.5. **Note**: These Guidelines will be quoted frequently throughout this book—so all OECD references (i.e., "OECD Guidelines" or "OECD-GL") will refer to these Guidelines unless indicated otherwise. The OECD-GL are arguably the main international reference for transfer pricing—reading this book will ensure that you are familiar with the most important provisions contained in the OECD-GL.

[2]See OECD Guidelines (2017a), Paragraph, 1.6.

O. Treidler, *Transfer Pricing in One Lesson*, Management for Professionals,
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service". Hence, even without further addressing pricing theory at this point,[3] the notion of a "natural uncertainty" of a specific price seems hardly controversial. The price agreed between two contracting parties will always depend on the specific circumstances of the transaction, i.e., considering factors such as the volume, the timing, and the prevailing market conditions.

Does the fact that pricing is a complex issue render the arm's length principle to be an "unworkable concept"? Well, I do not think so—therefore, I am bothering to write this book. The key point worth emphasizing here is that one should not clamor to misguided notions such as the "correct" or "true" price. Even in third-party transactions, a price list is usually not applied universally to all customers, as there will almost always be room to negotiate. Opposed to market transactions, intercompany transactions are, at least most of the time,[4] characterized by a lower degree of negotiation between the transacting parties (entities). That does not imply, however, that all (or even the majority of) MNEs have an automatic incentive to set their transfer prices in a way to minimize their overall tax bill. For MNEs (transfer) prices are of high importance in terms of being "market signals" for the efficient distribution of resources, i.e., to align incentives for the management with the objective of increasing the overall group profit. Distorting these signals is not necessarily the first thing that comes to mind. Yes, there are the Starbucks and Google out there, and we will discuss them in due course, but in general terms, there is no immediate reason why MNEs would purposefully misalign their transfer pricing from their business processes. In this context, the OECD correctly points out, and it is certainly worthwhile to remind some of the more overzealous tax auditors, that "Tax administrations should not automatically assume that associated enterprises have sought to manipulate their profits. There may be a genuine difficulty in accurately determining a market price in the absence of market forces or when adopting a particular commercial strategy."[5]

While identifying sufficiently comparable third-party transactions is one of the main challenges for transfer pricing professionals, it can always be achieved thanks to the flexibility of the arm's length principle. Also, it will most often be feasible to align market signals and the transfer pricing system applied for intercompany transactions. As a sensible starting point, one should embrace the concept that "transfer pricing is not an exact science"[6] (quoting the OECD's equivalent of the concept that there is no one "true" price). Consequently, transfer prices are often set by MNEs within a (broad) range of "comparable" arm's length prices. From an entrepreneurial point of view, this is sensible. A range of prices reflects differences in terms of market conditions, bargaining positions, and other phenomena prevailing in a market economy. As such, utilizing a range of prices as a reference for transfer pricing rather

[3]For an entertaining introduction (on the water-diamond paradox), I highly recommend the essay by Sanchez (2011).

[4]Note: Make no mistake—infighting among individual profit centers within an MNE can be fierce.

[5]See OECD-GL (2017a), Paragraph 1.2.

[6]OECD-GL (2017a), Paragraph 1.13.