Transfer pricing methods: selection and application from 2018

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While the lawmaker is in the process of revising the Taxes and Duties Act, adding new terminology to describe related parties and their mutual transactions, and contemplating the materiality threshold for a single controlled transaction or a category of controlled transactions that will determine whether related parties will have to file the master file and/or the local file of their transfer pricing (TP) documentation, it is already clear what TP methods taxpayers will be allowed to select for deciding whether the terms of their related-party transactions meet the arm's length standard. This article explores the TP methods described by the Cabinet of Ministers' Regulation No. 677 of 14 November 2017, *Application of Provisions of the Corporate Income Tax Act* (effective from 1 January 2018) as well as their selection and application.

TP methods

Paragraphs 13–17 of the Cabinet Regulation define methods a taxpayer will be allowed to use in applying the arm's length principle. There are still five TP methods, of which –

- four (the comparable uncontrolled price method, the resale price method, the cost plus method, and the transactional net margin method) are considered unilateral because the financial indicator is examined only in one of the parties to the transaction; and
- one (the profit split method) is regarded as combined because the combined profit is split between two or more parties according to the analysis of their contributions.

It is important to note that the TP method selection process is always aimed at finding the most appropriate method for a particular case, and the choice of method depends on the facts and circumstances of that case.

The comparable uncontrolled price method

Under paragraph 13 of the Cabinet Regulation, this method is applied to transactions involving goods and services with comparable prices.

Under generally accepted principles, this method involves comparing the price applied in a transaction between related parties –

- with the price of a related party's comparable transaction with an unrelated party (an internal price); or
- the price of a comparable transaction between other unrelated parties (an external price); or, where this is sufficiently comparable,
- with aggregated publicly available information about the prices of comparable transactions between unrelated parties (aggregated external price information).

Paragraph 1 of Annex 2 to the Cabinet Regulation offers an example of how the comparable uncontrolled price method is applied.

The resale price method

Under paragraph 14 of the Cabinet Regulation, this method is applied to a reseller's purchases from a related party if the reseller sells on to an unrelated party.

The price of resale to an unrelated party is reduced by a gross profit out of which the reseller should cover his selling and administration costs to arrive at a suitable margin, considering the functions performed, the associated risks, and the assets used for the conduct of the transaction, as well as other factors affecting its price.

Under generally accepted principles, this method involves comparing the resale price difference (gross margin) a reseller earns in a transaction between related parties –

- with the resale price difference (gross margin) the reseller earns on goods he buys and sells in comparable uncontrolled transactions (an internal comparable); or
- with the resale price difference (gross margin) earned by unrelated parties in comparable uncontrolled transactions (an external comparable).

The resale price difference (gross margin) is calculated as follows:

$$\text{Gross margin} = \frac{\text{Gross profit}}{\text{Net revenue}} \times 100$$

Paragraph 2 of Annex 2 to the Cabinet Regulation offers an example of how the resale price method is applied.

The cost plus method

Under paragraph 15 of the Cabinet Regulation, this method is applied to a seller's (manufacturer's) or service provider's transactions where goods or services are supplied to a related party.

An appropriate markup is added to the supplier's direct and indirect costs related to the controlled transaction, considering the functions performed, the associated risks, and the assets used for the conduct of the transaction, as well as other factors affecting its price.

Under generally accepted principles, this method involves comparing the markup a seller adds in a transaction between related parties –

- with a markup he applies in a comparable uncontrolled transaction (an internal comparable); or
- with markups applied by unrelated parties in comparable uncontrolled transactions (an external comparable).

The markup is calculated as follows:

$$\text{Markup} = \frac{\text{Gross profit}}{\text{Direct and indirect costs of good sold}} \times 100$$

Paragraph 3 of Annex 2 to the Cabinet Regulation offers an example of how the cost plus method is applied.

The transactional net margin method

Under paragraph 16 of the Cabinet of Ministers' Regulation No. 677, this method is applied like the resale price method or the cost plus method where comparing the gross margin of a controlled transaction or the markup on its direct and indirect costs with relevant financial indicators of unrelated parties fails to produce a sufficiently credible result based on factors affecting the transfer price.

Under generally accepted principles, this method involves comparing the net profit a taxpayer earns in a controlled transaction –

- with the net profit he earns in a comparable uncontrolled transaction (an internal comparable), or
- with the net profit earned by unrelated parties in comparable uncontrolled transactions (an external comparable).

Where goods or services are acquired from a related party, the net margin is calculated as follows:

$$\text{Net margin} = \frac{\text{Profit or loss before taxes}}{\text{Net revenue}} \times 100$$

Where goods or services are supplied to a related party, the net profit markup is calculated as follows:

$$\text{Net profit markup} = \frac{\text{Profit or loss before taxes}}{\text{Total cost of goods sold (operating cost)}} \times 100$$

Paragraph 4 of Annex 2 to the Cabinet Regulation illustrates how the transactional net margin method is applied.

The profit split method

Under paragraph 17 of the Cabinet Regulation, this method is applied to interdependent transactions where it is not possible to find comparable transactions between unrelated parties, or to transactions involving multiple related parties.

Under generally accepted principles, this method involves first measuring the combined profit resulting from related-party transactions and then splitting it in an economically sound manner between the related parties according to each party's contribution to the newly created value.

Paragraph 5 of Annex 2 to the Cabinet Regulation illustrates how the profit split method is applied.

Selecting a method

Under the Cabinet Regulation, the right method for determining the arm's length price of a transaction is selected according to the following factors:

- the economic substance of a controlled transaction (meaning that the actual transaction needs identifying), which is determined by conducting a functional analysis (paragraphs 8.1 and 10);
- the availability of credible information, in particular about transactions or financial indicators of unrelated parties (paragraph 8.2); and
- the degree of comparability between the controlled transaction and an uncontrolled transaction or financial indicators of unrelated parties, including any comparability adjustment made in order to exclude any material differences (paragraph 8.3).

Applying the chosen method

It is important to remember that –

- the arm's length price of a controlled transaction should be determined by applying one of the methods listed in the Cabinet Regulation (paragraph 9);
- an economic analysis of transactions (such as discounted cash flow analysis) can be applied as part of the methods if external statutory instruments of the related party's country of residence permit this (paragraph 9);
- publicly available information should be selected for comparability (paragraph 13.1);
- methods can be combined to arrive at a more accurate arm's length price of the transaction (paragraph 18);
- the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations can be used as an auxiliary source (paragraph 19).

When determining the period for gathering information about a comparable uncontrolled transaction, we can choose –

- an *ex ante* approach, which is based on the information that was reasonably available to the taxpayer at the time of entering into the transaction; or
- an *ex post* approach, in which the taxpayer tests the actual results of his controlled transactions and which is usually adopted as part preparing the CIT return during the preparation of annual accounts.

Comparability analysis

Applying these methods to transactions involves conducting a comparability analysis (paragraphs 11–12), in which the results of the functional analysis and the following comparability factors are considered:

- the industry sector;
- a similar geographical market;
- an existing independent trader;
- a functionally similar transaction;
- the subject matter of the transaction; and
- other factors affecting the transfer price.

Comparability analysis involves drawing up a list of key economic activities (functions) and identifying relevant risks based on the functions performed. Those risks should then be compared with comparable uncontrolled transactions or a comparable unrelated party. If material differences are found between the controlled transaction and the transactions or entities being compared, then mathematical calculations or reasonably accurate financial data adjustments can be made to avoid a significant effect on comparability.

We encourage you to consider these references to the new provisions of law coming into force in 2018, and we hope they will inform your company's commercial judgement about applying the arm's length principle and using transfer pricing analysis.