INTERNATIONAL TAX STRUCTURE & PRINCIPLE

- Presented by Ph.D Kwang-Ho Lee

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I. IMPORTANCE OF INTERNATIOAL TAX SYSTEM

- With the advance of globalization , the world economy has been integrating as a single market
  - MNEs has been expanding their territories in the world economy
  - International movement of growth factors such as capital, technology and enterprises as well as goods and service has been highly increasing.

  * World FDI Inward Flows: U$ 55.2bil. (1980) → U$ 201.5bil. (1990) → U$ 1.3tri.(2006)

- Globalization has affected on the environment of tax policy and systems as well as on the other areas.

I. IMPORTANCE OF INTERNATIOAL TAX SYSTEM

- The international characteristics of tax policy has been increased with the so called “globalization”
- In the past the tax policy had been regarded as a typical domestic policy but no longer with globalization
- A tax policy of a country might result in spill-over effects on the economy of other countries
- International tax competition has been emerged as one of main issues in the world tax area
  - Competitively since the second half of 1970s main countries have been decreasing the tax rates of corporate and individual income tax.

I. IMPORTANCE OF INTERNATIOAL TAX SYSTEM

- Ideally the single tax system with single jurisdiction worldwide could resolve many problems resulted from different tax systems with different jurisdictions.
  - But in the reality each country has different tax system because it is related to the sovereignty of each country

- In this situation each government in the world has been facing opportunities and challenges to attract investment and human resources with high expertise to develop its economy
  - The tax should not be obstacles for the promotion of international economic activities.

I. IMPORTANCE OF INTERNATIOAL TAX SYSTEM

- Risk of the double taxation on the foreign income without the relief system of double taxation
  - Residence country has right to tax on world wide basis of the resident
  - Source country has right to primarily tax on the source income of the non-resident

- Risk of the excessive taxation on the foreign income
  - Domestic tax law of most countries usually impose high withholding tax rates on the passive income of non- resident without tax treaties

I. IMPORTANCE OF INTERNATIOAL TAX SYSTEM

- Different tax system of each country might provide rooms for tax avoidances
  - MNEs could transfer the tax income to the region with lower tax rates by global transactions network
  - Without international tax cooperation it's hard to find appropriate oversea tax income

- International tax cooperation and the vast networks of tax treaties have been gaining importance
  - to support cross-border economic transactions
  - to prevent from tax avoidance with thems.

I. IMPORTANCE OF INTERNATIOAL TAX SYSTEM

- Tax treaty is central parts of international tax system in which include;

  - Relief of the double taxation
  - Limited tax rates on the investment income of non-resident such as dividends, interests and royalties
  - Transfer pricing
  - Mutual agreement as a way to settle the international tax disputes
  - Exchange of tax information
  - International tax collection cooperation

I. IMPORTANCE OF INTERNATIOAL TAX SYSTEM

- Other tools of internal taxation system
  - Controlled-Foreign Corporations(CFCs)
  - Thin Capitalization
  - Treaty shopping etc

II. GENERAL ASPECTS OF TAX TREATIES

HISTORICAL DEVELOPMENT OF TAX TREATY

- **Long history back to 1890s**
- **Expanded networks post WW II**
- **OEEC + OECD:**
  - 1956 study int'l double taxation
  - 1963 draft Model Tax Convention
  - 1977 Model
  - 1992 Model (loose-leaf to facilitate updates)
  - updates '94, '95, '97, 2000, 2003, 2005, 2008
- **UN Manual 1979 + Model 1980**
  - Updated 2001

II. GENERAL ASPECTS OF TAX TREATIES

CHARATERISTICS OF TAX TREATIES

- Mostly bilateral international treaties
- Incorporated into domestic law
- Generally follow the structure of the OECD Model
- Variations to take account of requirements of the contracting countries
- Not powered to generate the tax rights but to limit that of the contracting countries
- Vast network of tax treaties in world: 2800

II. GENERAL ASPECTS OF TAX TREATIES

CHARATERISTICS OF TAX TREATIES

- Tax or Not

Tax Law	Tax Treaty	Results
Tax Yes	Tax No	Tax No
Tax No	Tax Yes	Tax No
Tax Yes	Tax Yes	Tax Yes

II. GENERAL ASPECTS OF TAX TREATIES

PRIORITY OF APPLICAION OF TAX TREATIES

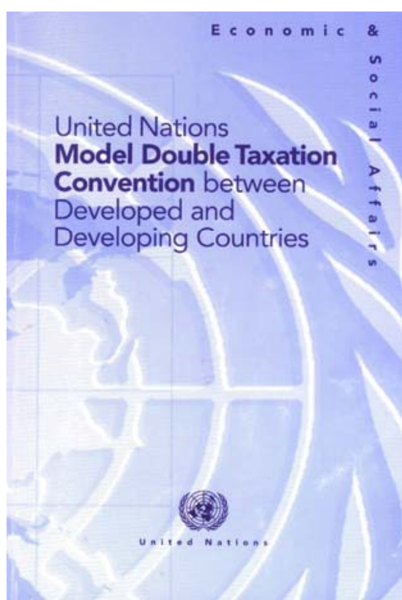
- KOREA, JAPAN, FRANCE
  Constitution > Tax Treaty > Tax Law

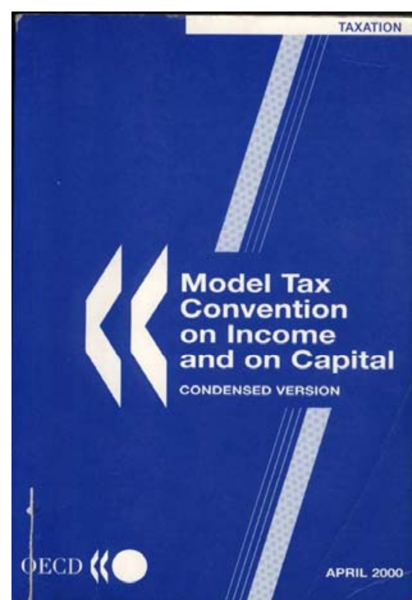
- U.S.A
  Constitution > Tax Treaty = Federal Law

- U.K.
  Constitution > Tax Law > Tax Treaty

II. GENERAL ASPECTS OF TAX TREATIES

Influential Organizations: OECD & UN





III. Structure of the OECD Model

- OECD Model Convention has seven chapters:

Chapter I	Scope Of Convention(1-2)
Chapter II	Definitions(3-5)
Chapter III	Taxation Of Income(6-21)
Chapter IV	Taxation Of Capital(22)
Chapter V	Methods Of Elimination Of Double Taxation(23)
Chapter VI	Special Provisions(24-29)
Chapter VII	Final Provisions(30-31)

OECD MODEL: SCOPE CHAPTER 1 (ARTICLES 1 – 2)

1. **To whom does the treaty apply?**
   - To residents of the contracting states

2. **Taxes covered**
   - Taxes on income
   - Taxes on capital
   - Taxes of central government and political subdivisions
   - List of taxes
   - Replacement and new taxes

DEFINITIONS CHAPTER II (ART. 3, 4 & 5)

3. General definitions

- Person
- Company
- Enterprise
- Enterprise of a contracting state
- International traffic
- Competent authority
- National
- Business
- Rule for undefined terms

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DEFINITIONS CHAPTER II (ART. 3, 4 & 5)

4. Resident

- Based on domestic law
- Tie breaker rules for dual resident individuals and non-individuals

5. Permanent establishment

- Fixed place of business
- Construction longer than 12 months
- Activities deemed not to be P.E
- Dependent agent with power to contract

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TAXATION OF INCOME CHAPTER III (ART. 6 – 21)

6. Income from immovable property

- Unrestricted taxation by source country allowed(OECD, UN)

7. Business profits

- Taxation of net profits by source country allowed to the extent that attributable to a permanent establishment therein
- Force of attractions(UN)

8. Income from shipping, waterways transport and air transport

- Exclusive taxation by the country where the place of effective management is located

TAXATION OF INCOME CHAPTER III (ART. 6 – 21)

9. Associated enterprises

- Right to adjust transfer prices
- Corresponding adjustment by other state

10. Dividends

- Taxation by source country limited to a certain percentage
- 5% if the beneficial owner is a company(25%treshold)
- 15% in all other cases
- Dividends connected with PE applied by Art. 7

11. Interest

- Taxation by source country limited to a certain percentage (less than 10%)
- Interests connected with PE applied by Art. 7

TAXATION OF INCOME CHAPTER III (ART. 6 – 21)

12. Royalties

- Exclusive taxation by the country of residence
- Payments for the use of, or the right to use industrial, commercial, or scientific equipment was deleted(1992)
- Royalties connected with PE applied by Art. 7

13. Capital gains

- Taxation by source country limited to gains on immovable property and business assets of a permanent establishment
- Taxation by source country on gains from alienation of immovable property shares or participation shares
- Taxation by resident country on others

14. Independent personal services

- [Deleted in 2000 update, now covered under article 7]

TAXATION OF INCOME CHAPTER III (ART. 6 – 21)

15. Income from employment

- Taxation of employment income by source country but exemption if employee is present for less than 183 days and the employer is non-resident with no PE

16. Directors' fees

- Taxation by country of residence of company

17. Artistes and sportsmen

- Taxation by source country is allowed
- Taxation to the income accrue to another person

TAXATION OF INCOME CHAPTER III (ART. 6 – 21)

18. Pensions

- Exclusive taxation by country of residence
- Pension under social security system shall be taxable only in the source country(UN)

19. Government service

- Exclusive taxation by country for which the services are rendered (exception for nationals and persons who are already residents of the other state):

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TAXATION OF INCOME CHAPTER III (ART. 6 – 21)

20. Students

- Payments from outside country of study not taxable there

21. Other income

- Exclusive taxation by country of residence except if income relates to a P.E.

22. Capital

- Source country taxation allowed for Immovable property & business assets of a permanent establishment or fixed base
- Special rule for shipping: place of effective management

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ELIMINATION OF DOUBLE TAXATION CHAPTER V (ARTICLE 23)

23. Methods for elimination of double taxation

- Two alternative methods:
  - Exemption method (art. 23 a)
  - Credit method (art. 23 b)
- Exemption method
  - Full exemption
  - **Exemption with progress**
- Credit method
  - Full credit
  - **Ordinary credit**
  - **Indirect tax credit**
  - Tax sparing credit

SPECIAL PROVISIONS CHAPTER VI (ART. 24 – 29)

24. Non-discrimination

- Non-discrimination on the base of nationals, PE or expenses-deductions

25. Mutual agreement procedure

- Present the case within 3 years from the first notification of the action resulting in taxation not accordance with the provisions of the Convention

26. Exchange of information

- For carrying out the Convention or domestic tax laws concerning taxes of every kind
- Confidential treatment: disclose only to persons or authorities(including courts) involved in the assessment, collection or appeal of tax and in the case of court rulings.

SPECIAL PROVISIONS CHAPTER VI (ART. 24 – 29)

27. Assistance in the collection of taxes(2003)
- ❖No restriction by Articles 1 & 2
- ❖Only in the OECD Model

28. Members of diplomatic missions and consular posts

29. Territorial extension
- No same article in the UN Model

FINAL PROVISIONS CHAPTER VII (ARTICLES 30 – 31)

30. Entry into force of the convention
- ❖Date of entry into force
- ❖Date of effect

31. Termination of the convention
- By giving notice of termination at least 6 months before the end of any calendar year after the year …..

PROTOCOLS

- Provisions form an integral part of the Convention
- Agreed at time of convention or subsequent
- Uses:
  - ❖Clarifications, deviations, updates and modification

IV.Main Differencies Between the OECD and UN MODELs

- Article 5(PE):
  - ❖ Construction regarded as PE is expanded (paragraph 3)

(OECD) A building site or construction or installation project …only if it lasts more than 12 months.

(UN) A building site, a construction, assembly, or installation project, supervisory activities in connexion therewith, but only where such site, project or activities continue for a period of more than 6 months.

IV.Main Differences between the OECD and UN Models

- Article 5(PE):
  - ❖(UN) Delivery omitted from paragraph 4(no PE)

    "… facilities soly for the purpose of storage or display of goods ….."

  - ❖ (UN)

    Paragraph 5(b) is added on Dependant agent which is regarded as PE

    "… habitually maintain in the first mentioned state a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise"

IV.Main Differences between the OECD and UN Models

- Article 5(PE):
  - ❖Insurance (paragraph 6) in UN

    Insurance enterprise except reinsurance shall be deemed to have PE if it collect premium or insures risks through a person other than an independent agent

- Article 7(Business Income)
  - ❖ Force of attraction rule in para.1 in UN

    (b) profits is attributable to sales of goods of the same of similar kind as those sold through that PE or (c) other business activities carried on of same or similar kind as those of PE.

IV.Main Differences between the OECD and UN Models

- Article 7(Business Income)
  - ❖ Rolyalties, intersts and fees between PE and the head office of the enterprise are not allowed to the deduction and profits of PE(UN para 3)

  ※ Commentary of OECD include same contents

  - ❖ No tax on the mere purchase by PE in OECD is deleted in UN.

IV.Main Differences between the OECD and UN Models

- Article 8(Shipping, inland, waterways transport and air transport)
  - ❖ UN include alternative "b"

    limited source state taxation of international shipping in case that the operations is more than casual

- Article 10(Dividends)
  - ❖ UN: rate is not specified and ownership threshold is lower (10%)
  - ❖ OECD: rate is 5-15%, threshold is 25%

IV.Main Differences between the OECD and UN Models

- Article 11(Interest)
  - ❖ UN: limited tax rate is not specified
  - ❖ OECD: rate is less than 10%
- Article 12(Royalties)

  <taxation>
  - ❖ UN: source state(payer's state) taxation is possible, rate is not specified,
  - ❖ OECD: resident state taxation only

  <scope of royalties>
  - ❖OECD: "the right to use industrial, commercial, or scientific equipment" is deleted in 1992

IV.Main Differences between the OECD and UN Models

- Article 13(Capital Gains)
  - ❖ OECD: source state taxation of shares if more than 50% of value of the alienated share is from immovable property
  - ❖ UN: rate not specified
- Article 14(Independent Personal Services)
  - ❖ deleted from OECD model(fixed base)
  - ❖ UN Model additional criteria: 6 month and amount threshold
- Article 16(Director's Fees)
  - ❖ UN: extends scope(directors + high level managers)

IV. Main Differences between the OECD and UN Models

- Article 18(Pensions)
  - ❖ OECD: pensioner resident state tax only
  - ❖ UN: two alternatives
    (A) pensioner resident state tax only
    (B) if the payment is made by a resident of the other contracting state, the other state taxable
  - ❖ UN: Pension under social security system shall be taxable only in the source country

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IV. Main Differences between the OECD and UN Models

- Article 21(Other Income)
  - ❖ OECD: resident state taxation only
  - ❖ UN: Other income arise from the other contracting state taxable in the source state
- Article 27(Assistance in the Collection of Taxes)
  - ❖ UN: no equivalent provision (2003 OECD addition)

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V. Further Studies on Important Articles

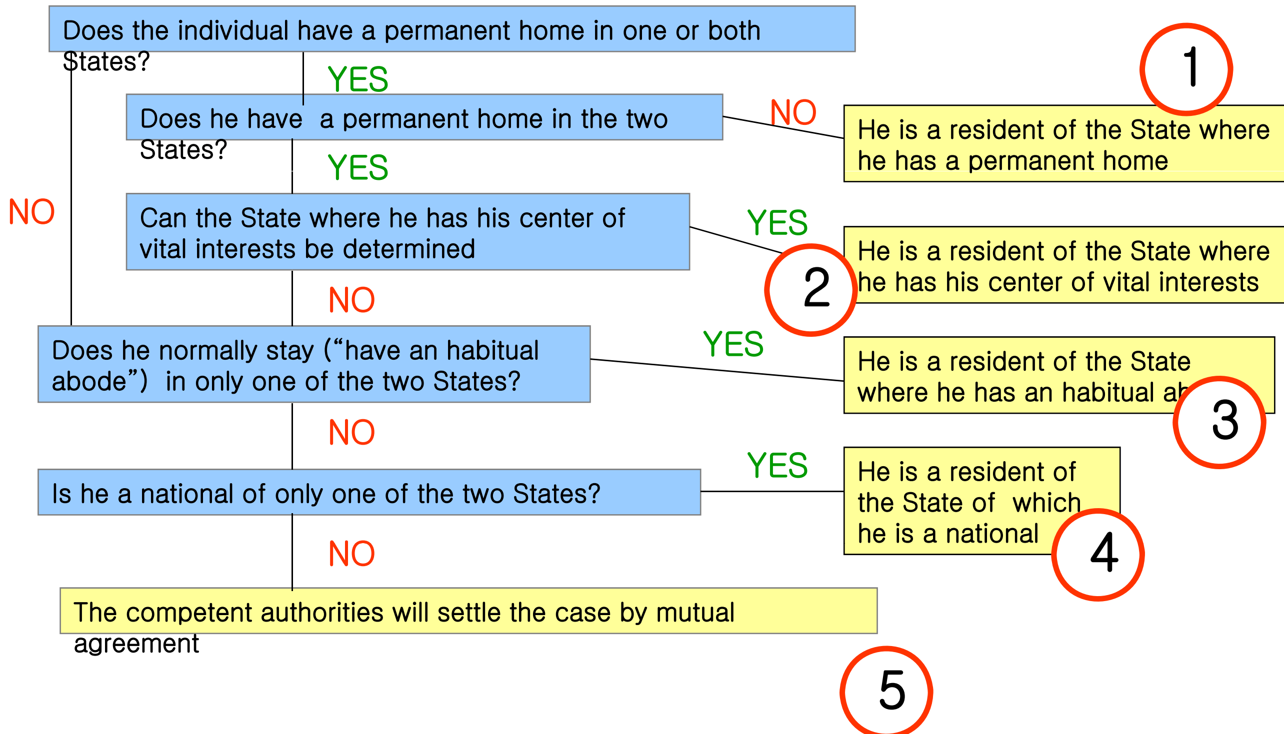
Resident: Article 4(Overview)

- **paragraph 1** :“resident of a contracting state” is defined as a person who is subject to worldwide taxation in the state on the base of certain criteria
- **paragraph 2** : tie-breaker rule for individual
- **paragraph 3** : tie-breaker rule for other persons

Definition Of Resident: Article 4 (1)

- Based on domestic law: person is resident of a country if liable to tax in the country by reason of his:
  - Domicile
  - Residence
  - Place of management
  - Or similar criterion
- But does not include someone who is taxable only on income from sources in the country (a non-resident)
- Residence in relation to a treaty may change at a point of time during a fiscal year, typically when a taxpayer's circumstances change

Resident: Tie-breaker for Dual Resident Individuals (Article 4 (2))



Tie-breaker For Other Entities (Article 4 (3))

- OECD and UN Models adopt place of effective management
  - Where the key management and commercial decisions are in substance made
  - Ordinarily where the most senior person or persons (the bo ard?) make those decisions
  - Where the actions to be taken by the entity as a whole are taken
  - Look at all facts and circumstances
- Common alternatives:
  - Place of incorporation
  - Mutual agreement procedure:
    - with or without guidance
    - If no agreement, taxpayer loses treaty benefits

Rule in Article 7 (Business Profits)

- Allocation of taxing jurisdiction for business profits (Art 7(1)):
  - Business profits taxed exclusively in the State of residence of the enterprise unless there is a "permanent establishment (PE)" in the other State
  - If a PE exists, profits attributable to the PE taxable in the PE State.

Rules in Article 7 (Business Profits)

- **paragraph 2** - primary rule for allocation of profits to a PE – profits the PE might be expected to make if it were a separate and independent enterprise
- **paragraph 3** – If one State adjusts the profits of the PE and taxes accordingly, the other State shall make an appropriate adjustment.
  - When necessary – competent authorities shall consult each other
- **paragraph 4** - other articles have priority over Article 7

Profit allocation rules - Article 7 v. Article 9

- Article 7 is concerned with transactions between parts of the same legal entity
- Article 9 is concerned with transactions between separate, but related, entities
- Both based on the arm's length principle

QUICK TOUR OF ARTICLE 5

- Para 1 primary rule
- Para 2 illustrative list of para 1 PEs
- Para 3 construction/installation projects
- Para 4 activities not PEs
- Para 5 dependent agents may be a PE
- Para 6 independent agents not a PE
- Para 7 control of a subsidiary not a PE of the parent

A Fixed Place of Business PE

- Paragraph 1 of OECD and UN Models included in almost all tax treaties:

  "For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of the enterprise is wholly or partly carried on.

- Essential characteristic: Distinct "sites" , a fixed place of business, for sufficient duration

Condition 1: A place of business

- Any premises, facilities or installation
  - ❖used for carrying on the business
  - ❖whether or not used exclusively for that purpose
- Space is at its disposal
- Immaterial whether owned, rented or at the disposal of the enterprise - No formal legal right to use required
- ▪ Example 1 - mere presence is not sufficient
  - ❖ See salesman example (paragraph 4.2) - No
- ▪ Example 2 - Use of an office by enterprise, for that enterprise's business - yes
- ▪ Example 3 - Truck loading bay visited regularly - No
- ▪ Example 4 - Painter works on a client's building - Yes

Condition 2: fixed place of business

- Two critical components of "fixed":
  - a certain degree of permanence (the "duration test") at each geographical spot
  - a specific geographical spot (the "location test")

<Fixed 1: Sufficient duration>

- Regardless of where a short term activity is carried on in the source state, if there is insufficient duration, there is no PE (same applies under the UN Model).
- Guidance in the OECD Commentary:
  - less than 6 months, probably not a PE
  - 6 to 12 months, possibly a PE
  - 12 months likely to be a PE

Condition 2: fixed place of business

- Temporary interruption of operations is not closure.
- Rule for determining whether a PE exists, but some of the expenses incurred before the PE is established may be attributable to the PE.

<Fixed 2 : Location test>

- If there is no distinct place - then there is no PE (even if long duration)
- What is the extent of the location, (e.g.) a single office or various offices of a building?
- <u>Coherent whole commercially and geographically</u>
- A place <u>regularly returned to: (e.g.)</u> street market

Condition 3: Carry on the business through the PE

- Must carry on the business of the enterprise (wholly or partly) through the PE
- To be given a wide meaning - any situation where business activities are carried on at a particular location at the disposal of the enterprise for that purpose

PARAGRAPH 2: EXAMPLES OF PEs

- Examples of typical fixed places of business
  - Place of management, Branch, Office, Factory, Workshop, Mine, Oil or gas well, Quarry or any other place of extraction of natural resources
- Must meet the requirements of paragraph 1
- Not exhaustive
- "Typical"?: technological advances in business operations

Paragraph 3: Building Sites , Construction and Installation Projects

"3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months."

- Special rule for an activity that by nature is temporary
- 12 months minimum period in OECD Model, but adoption of 6 months(UN) is common
- Is the construction site a PE for all contractors?
- Construction or a project conducted at multiple sites
- Subcontracted contracts

Article 5 (4) Activities deemed not to be a PE

- "Permanent Establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of **storage, display or delivery** of goods or merchandise belonging to the enterprise;

b) **the maintenance of a stock of goods or merchandise** belonging to the enterprise solely for the purpose of **storage, display or delivery**;

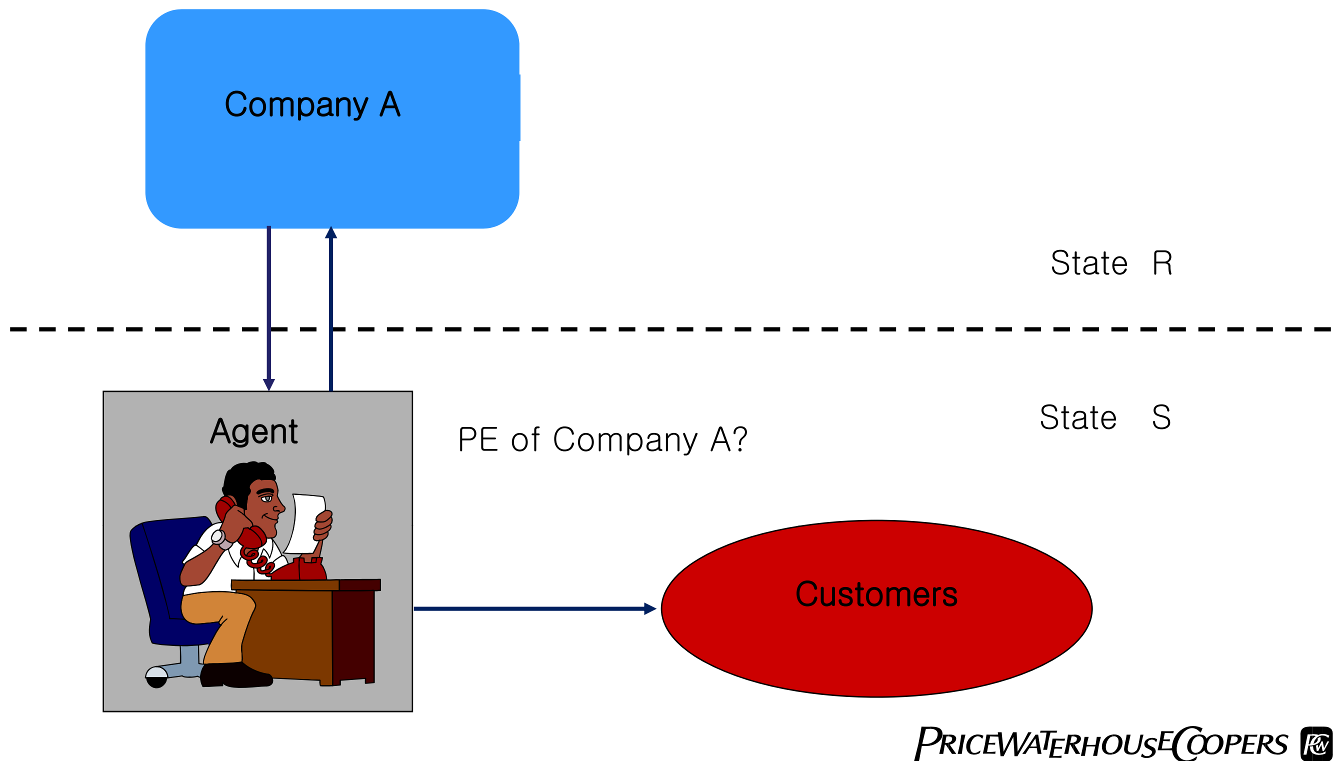
c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose **of processing by another enterprise**;

d) the maintenance of **a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information**, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of **a preparatory or auxiliary character;**

f) the maintenance of a fixed place of business solely **for any combination of activities mentioned in subparagraphs a) to e),**

Agents - Paragraphs 5 and 6



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Does a dependent agent PE exist?

- Not an independent agent ?
- Acting on behalf of the enterprise ? (or In the name of the enterprise?)
- Habitually exercises in the State ?
- An authority to conclude contracts ?
- Not covered by paragraph 4 ?

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Paragraph 7 - Parents & Subsidiaries

- A Clarification: the relationships which exist between parent and subsidiary as such and between fellow subsidiaries as such do not of themselves make one company a permanent establishment of another company
- A subsidiary may act as the dependent agent of its parent or fellow subsidiary and its premises may be used as a fixed place of business of the parent or a fellow subsidiary - this is a question of fact

Article 23: Double Taxation Relief

- Deduction method: Allowing taxpayers to claim a deduction for taxes paid to a foreign country
- Exemption method: Providing taxpayers with an exemption for foreign-source income
- Credit method: Providing taxpayers with a credit against taxes otherwise payable for income taxes paid to a foreign country

Comparison of Methods for Double Taxation Relief

	Deduction method	Exemption method	Credit method
Foreign-source Income	100	100	100
Foreign Tax (40%)	40	40	40
Deduction for Foreign Tax	40	nil	nil
Net Domestic Income	60	nil	100
Domestic Tax Before Credit (50%)	30	nil	50
Less: Foreign Tax Credit	nil	nil	40
Final Domestic Tax	30	nil	10
Total Domestic & Foreign Tax	70	40	50

Tax Sparing Credit (TSC)

- Concept: A credit granted by the resident country for foreign taxes that were not actually paid to the source country but that would have been paid under the country's normal tax rules
- Without TSC, actual beneficiary of a tax incentive provided by a source country to attract foreign investment may be the resident country rather than the foreign investor

Comparison of Effects of TSC

	Exemption method	Credit method Without TSC	Credit method With TSC
Foreign-source Income	100+100	100+100	100+100
Foreign Tax (0 %, 30%)	0+30	0+30	0+30
Deduction for Foreign Tax	nil	nil	nil
Net Domestic Income	nil	100+100	100+100
Domestic Tax Before Credit (50%)	nil	50+50=100	50+50=100
Less: Foreign Tax Credit	nil	0+30=30	30+30=60
Final Domestic Tax	nil	70	40
Total Domestic & Foreign Tax	30	30+70=100	30+40=70

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Korea's Treaty Policy on TSC

- Seeking TSC until 1980s when negotiating with developed countries
- Chang its position when joining the OECD
- Sunset clause when revising tax treaty with developed countries
- Allowing TSC to developing countries with sunset clause and anti-abuse provisions

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Thank You.

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Training Material – Transfer Pricing

Attorneys at Law YULCHON

September 2011

Presented by Dr. Kyung Geun LEE

Contents

I. Introduction to Transfer Pricing

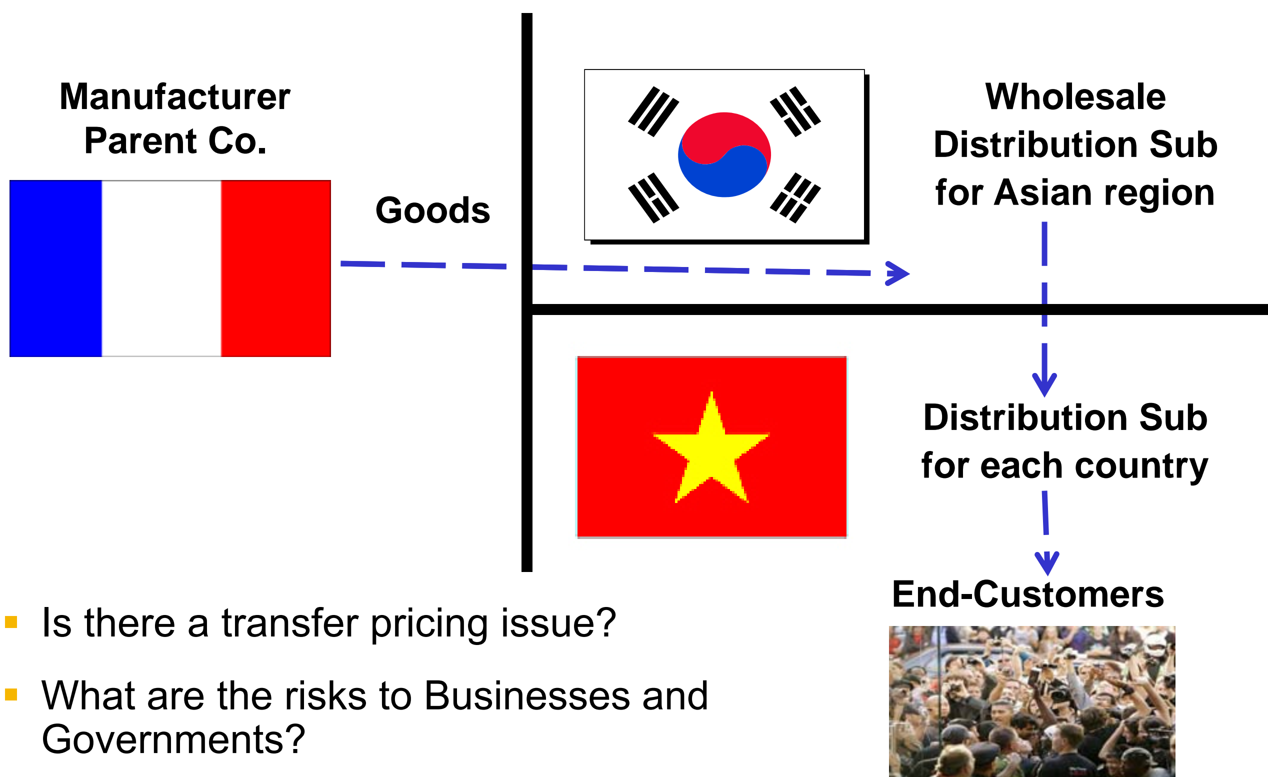
II. Arm's Length Principle and Comparability

III. Transfer Pricing Methods

IV. Revision of OECD TP Guidelines

I. Introduction to Transfer Pricing

What is Transfer Pricing?



- Is there a transfer pricing issue?
- What are the risks to Businesses and Governments?

Relevance of the Subject

- Approximately 60-70% of the world trade carried on within Multinational Groups of Enterprises (MNEs)
- Cross-border dimension of transactions...
- ...due to globalization and economies of scale
- Transfer prices ... are prices at which an enterprise transfers goods, services or intangible property to associated enterprises

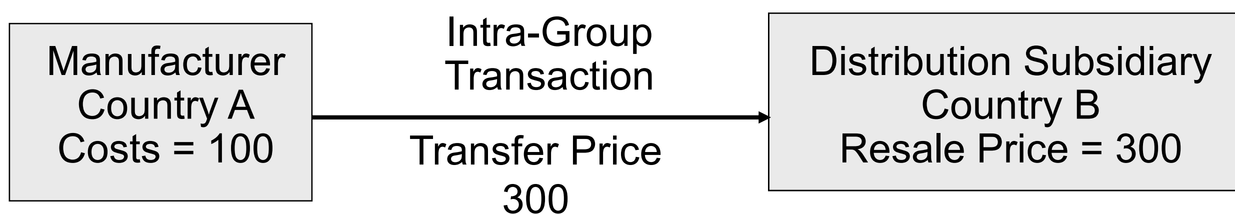
Relevance of the Subject, *cont'd*

- Transfer Pricing Regimes: Reliance on the Arm's Length Principle (ALP)...
- ALP entails the Separate Entity Approach, i.e. associated enterprises are taxed as if they were dealing wholly independently (i.e. at arm's length)
- Global formulary apportionment approach: An approach to allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined formula

Transfer Pricing Adjustment

Profit A	Intra-Group Transfer Price	GrossProfit B	Total Profit
50	150?	150	200
100	200?	100	200
150	250?	50	200
200	300?	0	200
250	350?	- 50	200

Transfer Pricing Adjustment, *cont'd*



Profit A = 200
Tax 25% = 50

Profit B = 0
Tax 30% = 0

Total = **200**
Total = **50**

- Multinational Groups of Enterprise can adjust the total tax burden by adjusting the transfer price.
- OECD TP guideline provides a international transfer pricing standard for MNEs and tax administrations.

II. Arm's Length Principle and Comparability

Comparability – what for? Arm's Length Principle

- Arm's Length Price: the price which would have been agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions in the open market.

- Definition: Article 9 (1) OECD Model Tax Convention:

  "(….) *if **conditions** made or imposed between associated enterprises in their commercial or financial relations differ from those which would have been made between independent enterprises, then profits that, but for those conditions, would have accrued to one of the enterprises may be included in the profits of that enterprise and taxed*".

- Commentary on Article 9 (1)

  Paragraph 2: "*normal open market commercial terms*"

Comparability – what for Arm’s Length Principle

- Transfer Pricing Regimes: Reliance on the Arm‘s Length Principle (ALP)...
- ALP entails the Separate Entity Approach, i.e. associated enterprises are taxed as if they were dealing wholly independently (i.e. at arm‘s length)
- Global formulary apportionment approach: An approach to allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined formula

What does “comparable” mean?

- To be comparable means that
  - None of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or
  - Reasonably accurate comparability adjustments can be made to eliminate the effect of any such differences.
- “Comparable” does not mean “identical”, but the comparison must be reasonably reliable (very similar, substitutable)

5 Factors determining Comparability
(paragraphs. 1.19 – 1.35 OECD Guidelines)

Factors	Importance
1. Characteristics of property/service **2. Functional analysis**	**Very important!**
3. Contractual terms 4. Economic circumstances 5. Business strategies	**Less important**

- Make appropriate comparability adjustments for any substantial differences between the compared transactions/enterprises!
- Determine an arm's length range!

Arm's length range

- The application of the most appropriate method or methods might produce a range of figures all of which are relatively equally reliable → arm's length range
- Differences in the figures that comprise the range may be due to:
  - Arm's length principle only produces an approximation of conditions
  - The fact that independent enterprises engaged in comparable transactions do not establish exactly the same price
  - Application of more than one method

Arm’s length range, *cont’d*

- Any point in the arm’s length range satisfies the arm’s length principle
- If an adjustment is made by the tax administration, it should be made “to the point within the range that best reflects the facts and circumstances of the controlled transaction.”

Typical Process in 10 Steps for Identifying Comparable Transactions and Using Data

Step 1: Determination of years to be covered

Step 2: Broad-based analysis of the taxpayer’s circumstances

Step 3: Understanding the controlled transaction(s) under examination in order to choose the tested party, the most appropriate TP method, identify the relevant factors that will influence both the choice of the appropriate method(s) and the comparability analysis

Step 4: Review of existing internal comparables, if any

Step 5: Determination of available sources of information on external comparables

Typical Process in 10 Steps for Identifying Comparable Transactions and Using Data, *cont'd*

Step 6: Selection of the relevant transfer pricing method(s) and, depending on the method(s), determination of the relevant indicator

Step 7: Identification of potential comparables: defining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparables

Steps 5 – 7 might be repeated

Step 8: Determination of and making comparability adjustments where appropriate

Typical Process in 10 Steps for Identifying Comparable Transactions and Using Data, *cont'd*

Step 9: Interpretation and use of data collected, determination of the arm's length remuneration

Step 10: Establish, monitor and review transfer prices

III. Transfer Pricing Methods

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5 TRANSFER PRICING METHODS

TRADITIONAL TRANSACTION METHODS

- Comparable uncontrolled price (CUP) method
- Cost-plus method
- Resale price method

TRANSACTIONAL PROFIT METHODS

- Transactional Net Margin Method (TNMM)
- Profit Split Method
  - Contribution Analysis
  - Residual Analysis

Selection of TP Method

- In the past, general preference for traditional transaction methods over transactional profit methods
- Selection process of the most appropriate method for a particular case should take account of

i) The respective strengths and weaknesses of each of the OECD recognised methods;

ii) The appropriateness of the method considered in view of the comparability (including functional) analysis;

iii) The availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods;

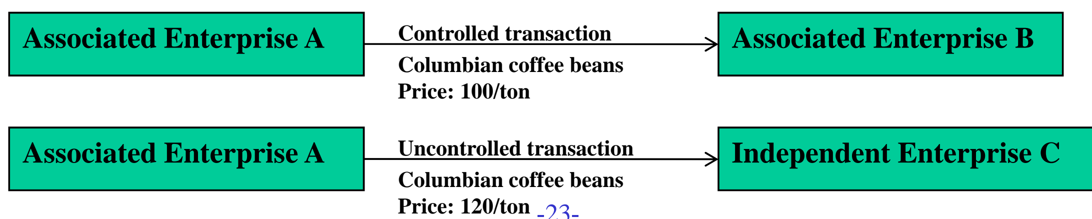
iv) The degree of comparability of controlled and uncontrolled transactions including the reliability of comparability adjustments that may be needed to eliminate differences between them.

Comparable Uncontrolled Price (CUP) Method

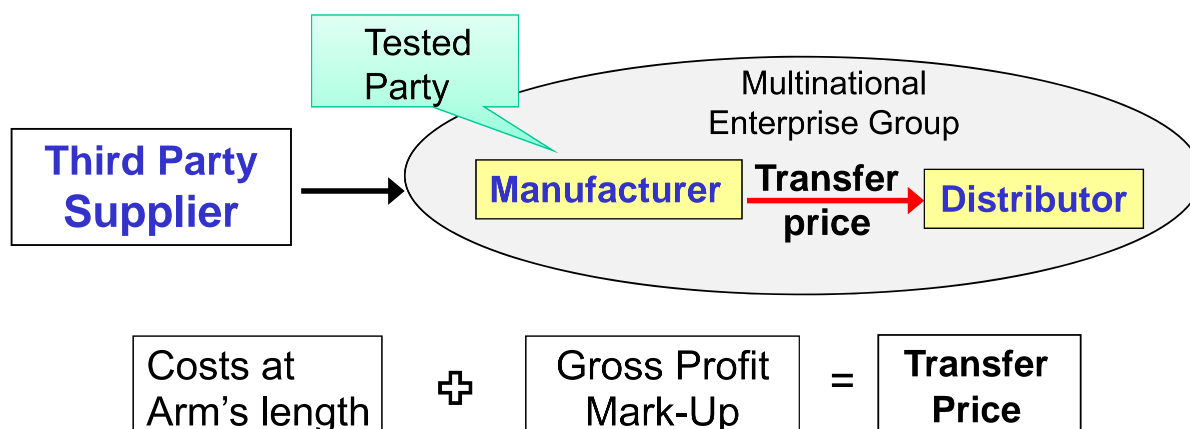
- CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.
- Preferred method if comparable uncontrolled prices can be found
- An uncontrolled transaction is comparable to a controlled transaction for purposes of the CUP method if one of two conditions is met:
  - None of the differences (if any) between the transactions being compared or between the enterprises could materially affect the price in the open market; or
  - Reasonably accurate adjustments can be made to eliminate the material effects of such differences.

Comparable Uncontrolled Price (CUP) Method, *cont'd*

- The fair market price for comparable goods, services or loans between independent companies
- Difficulties in finding comparables:
  - Goods or Services
  - Market (ex. geographical differences)
  - Market-level (wholesale or retail)
- If no exact comparables → comparability adjustments for the differences
- Method can best be used for commodities, raw material, agricultural products, chemical base products, financial products (e.g. interest rates)



COST PLUS METHOD



- Calculate gross profit mark-up for manufacturer
- Easiest to apply for semi-finished goods
- Most useful where the tested party does not contribute valuable unique intangible assets or assume unusual risks in the controlled transaction (e.g., a contract or toll manufacturing arrangement)

COST PLUS METHOD, *cont'd*

Example:

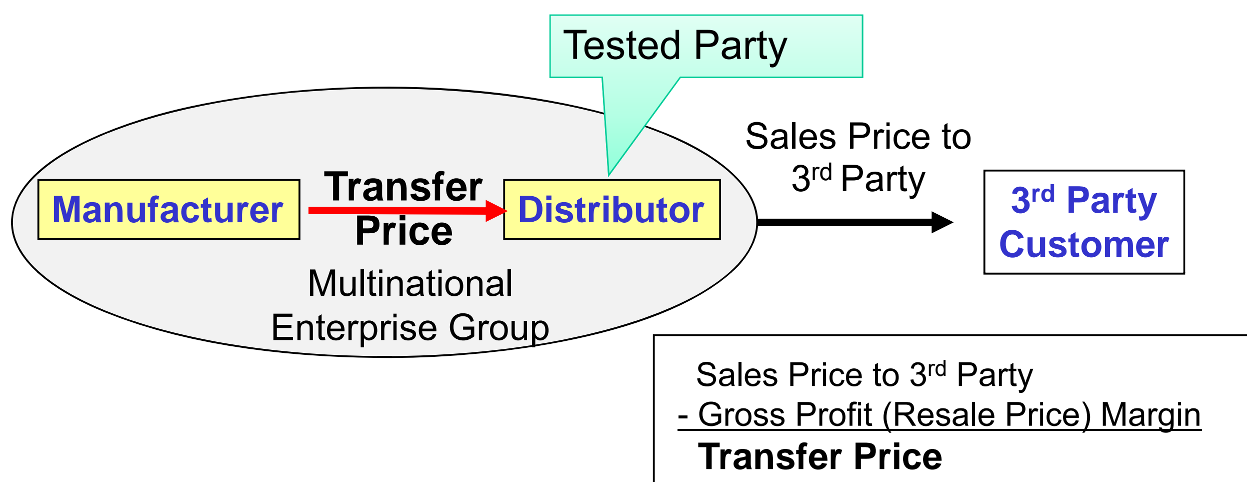
Manufacturing Costs $ 80
Gross Profit Margin (Mark-up) 25% ← Determined from comparable companies/transactions

Cost + **Mark-up on cost**

Arm's Length Transfer Price = $ 80 + ($ 80 x 25%) = **$ 100**

- Focus on function
- Benchmark is comparable (arm's length) gross profit mark-up on costs

RESALE PRICE METHOD



- Calculate gross margin for distributor/reseller
- Easiest to apply if reseller does not add substantially to value of product

RESALE PRICE METHOD, *cont'd*

Example:

Sale Price to Third Parties $ 100
Resale Price margin 20% ← Determined from comparable companies/transactions

Sales Price – **Resale Price Margin**

Arm's Length Transfer Price = $ 100 - (20% x $100) = **$ 80**

- Focus on function; useful for a distributor
- Benchmark is comparable (arm's length) gross profit margin (discount)

What is a "profit method"?

- Uses net profitability to judge transfer pricing
- Must be Transactional
  - Total profit comparisons can only be used to select cases but not to examine them

Transactional Net Margin Method (TNMM)

- OECD TP Guidelines 2.58
  - “[TNMM] examines the net profit margin relative to an appropriate base (e.g.. costs, sales, assets) that a taxpayer realizes from a controlled transaction….
  - The arm’s length net profit indicator (i.e. a ratio of net profit relative to an appropriate base) of the taxpayer from the controlled transaction may be determined by reference to the net profit indicator of internal comparables or external comparables.
  - Must be applied in a manner consistent with resale price/ cost plus method

TNMM: Comparability Analysis (I)

- What factors influence net profit?
  - Net profit may be affected by factors unrelated to transfer prices
- TNMM uses net profit margins, i.e. net profit margin computed after all operating expenses (except interest, taxes and extraordinary items)
- Examine factors affecting operating expenses
  - Management efficiency
  - Competitive position
  - Business experience
  - Varying cost structures

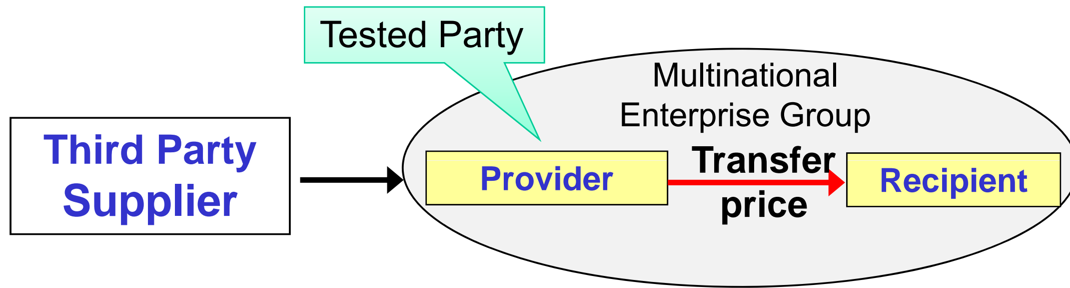
Difference between TNMM & Resale Price Method

Item	Amount
• Sales revenue (sales to independent customers)	1,000
• Cost of goods sold (purchases from associated enterprise)	(400)
• Gross profit (e.g. 60% of sales)	600 (←RPM)
• Selling and other operating expenses	(400)
• Operating profit (e.g. 20% of sales)	200 (←TNMM)
• Financial items	+10
• Exception items	(30)
• Pretax profit (EBT, earnings before taxes)	180
• Income tax	(60)
• Net profit	120

Difference between TNMM & Cost Plus Method

Item	Amount
• Cost of raw materials	200
• Other direct and indirect production costs	100
• Total cost base	300
• Mark-up on Costs (e.g. 20% of costs)	60 (←CPM)
• Transfer price	360
• Overheads and other operating expenses	(45)
• Operating profit (e.g. 5% of costs)	15 (←TNMM)

TNMM: Example



Selected Net Profit Indicator: Full Cost Mark Up

Total Cost (COGS + Operating Expenses) ✕ 1 + Net Profit Mark Up = **Transfer Price**

- Easiest to apply for
  - Services

TNMM: Example, *cont'd*

Example:

COGS	$ 100
Operating Expenses	$ 50
Net Profit Mark Up Ratio	10%

← **Determined from comparable companies /transactions**

Total Cost (COGS + Operating Expenses) ✕ 1 + Net Profit Mark Up

Arm's length Transfer Price = ($100 + $50) X (1+10%) = **$ 165**

Profit Split Method

- Where transcriptions are very interrelated: they cannot be evaluated on a separate basis
- Under similar circumstances, independent enterprises may decide to set up a form of partnership and agree to a form of profit split
- Also a transactional method
- 2 types of profit split method
  - Contribution Analysis (total profit split)
  - Residual Analysis (residual profit split)

PS: Contribution analysis

- Compute combined net profit
- Examine functions
- Determine relative value (value added)
  - Some factors: expenses incurred, assets used, payroll
- Examine external data
- Assign a profit split percentage

PS: Residual analysis - 2 Step approach

- Compute combined net profit of associated enterprises and examine functions performed (routine and non-routine)

Step 1

Use other methods (CUP, Cost Plus, Resale Price, TNMM) to assign basic return to each (routine) function of each company

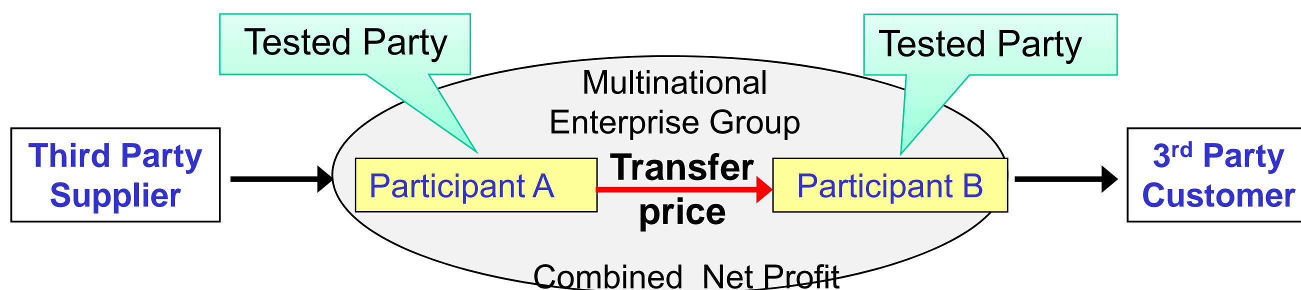
- Often can assign profit from activities not involving significant intangible property
- Examples: distribution function (resale price); manufacturing function (cost plus), possibly some TNMM applications

Step 2

Divide residual profit according to a contribution analysis

- R&D and/or marketing expenditures may be relevant

PS: Example (Total Profit Split)



Combined Net Profit ✕ Contribution Ratio of Participant A = **Arm's length Profit of Participant A**

Combined Net Profit ✕ Contribution Ratio of Participant B = **Arm's length Profit of Participant B**

PS: Example (Total Profit Split), *cont'd*

Example:

Combined Revenue	$ 300
Combined Expenses	$ 150
Combined Net Profit	$ 150
Contribution Ratio of Participant A	60%
Contribution Ratio of Participant B	40%

Determined from comparable companies /transactions or relative value of functions performed by each tested party

Combined Profit ※ Contribution Ratio

Arm's length Profit of Participant A	=	$ 150	X	60%	=	**$ 90**
Arm's length Profit of Participant B	=	$ 150	X	40%	=	**$ 60**

IV. Revision of OECD TP Guidelines

Revision of OECD TP Guidelines

- The OECD has released a new Transfer Pricing guidelines revising part Chapter I~III and inserting Chapter IX on Business Restructuring.
- The main changes on Chapter I~III are as follows;
  - Hierarchy of Transfer Pricing methods
  - Comparability analysis
  - Guidance on the application of transactional profit method; and
  - Annexes

Hierarchy of TP methods

- In the previous guideline, there are two categories of OECD-recognized TP methods;
  - Traditional transaction methods; and
  - Transactional profit method
- In the past, transactional profit method (TNM, PS) had a status of last resort methods, to be used only exceptional cases where there are no or insufficient data available.
- The OECD removed exceptionality and replaced it with a standard whereby the selected transfer method should be the most appropriate method to the circumstances of the case.

Thank you

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Training Material
– Transfer Pricing Case Study

Attorneys at Law YULCHON

September 2011

Presented by Dr. Kyung Geun Lee

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I. Movie/Video distribution

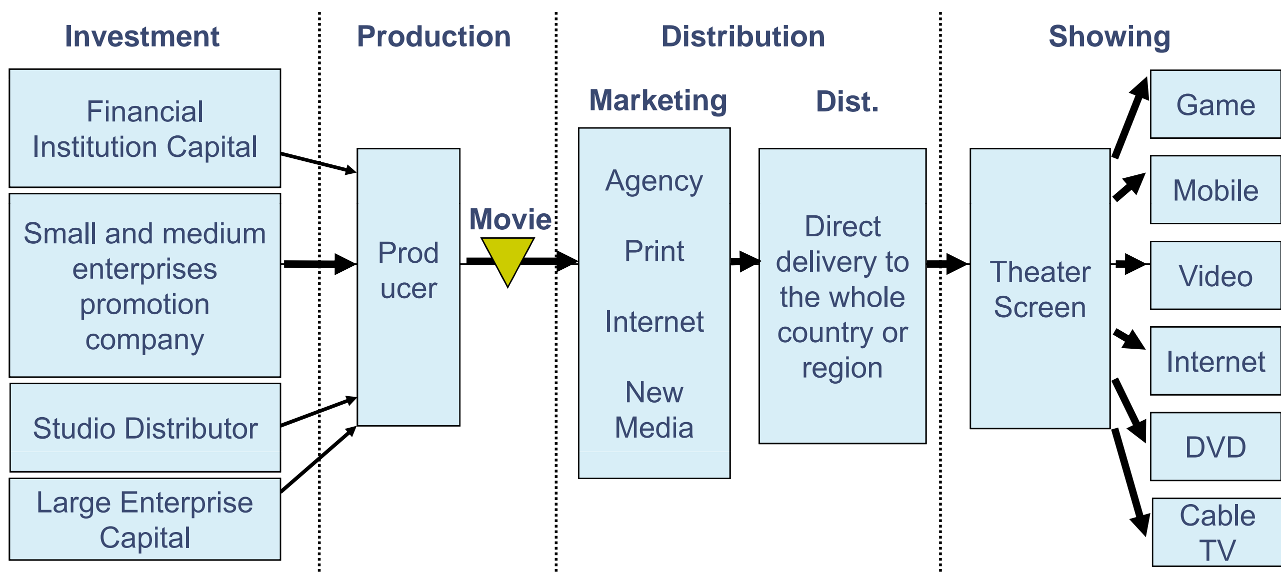
II. Pharmaceutical

I. Movie/Video Distribution

1. Understanding of the industry
2. Background
3. TP adjustment by the tax authority
4. Key issues
5. Implication

1. Understanding of the industry

Structure of the movie distribution in Korea



* Source: [Structure of the movie industry in Korea] Movie promotion committee, 2002

1. Understanding of the industry

Copyright

- In relation to movie rights, copyright is the biggest asset
- The copyright initially belongs to the production company, though the distribution company recently tends to exercise rights on behalf of the production company through a transfer of the copyright, and shares profit

License agreement

- Movie transactions (i.e., import and distribution) are generally conducted via a license agreement. These transactions require that a royalty is paid to the license holder.

Royalty types

- Flat deal : pays a certain amount of royalty per each movie
- Minimum guarantee : pays a minimum guarantee fee initially, then a running guarantee is applied based on the copyright usage fees for different channels

2. Background

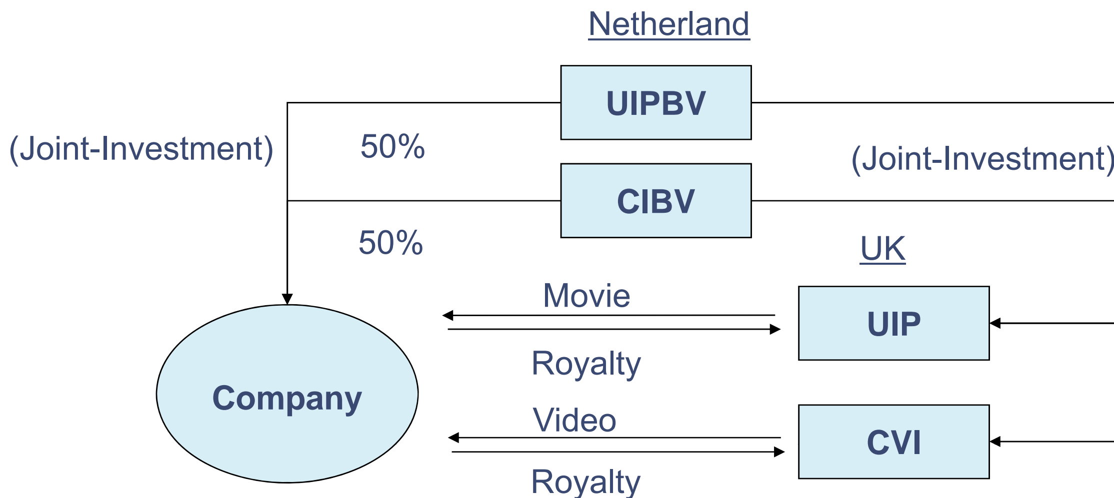
Company and transaction summary

- **Company**
  - United International Pictures Inc. ("UIP") established in 1988 via 50:50 joint investment of United International Pictures BV ("UIPBV"), a Dutch movie distribution company, and Cinema International Pictures BV ("CIBV"), a video distribution company
- **Transaction summary**
  - The Company (plaintiff) received movies and videos from UIP and CIC Video International ("CVI") and paid royalties
- The Company paid a following portion of its revenue as royalties for FY1990 and FY 1991

Classification	FY 1990	FY 1991
Movie (paid to UIP)	69.47% (51.91%)	59.92% (49.82%)
Video (paid to CVI)	51.13% (49.41%)	57.89% (47.12%)

2. Background

Transaction structure



3. TP adjustment by the tax authority

- The tax authority determined the arm's length price based on the Comparable Uncontrolled Price ("CUP") method
- The Company proposed the following as comparable transactions
  - Movie: a percentage of the royalty (that Pan Asia Ltd., an independent enterprise in Hong Kong, has paid to UIP) out of the total sales amount
  - Video: a percentage of the royalty (that King Video Ltd., an independent enterprise in Taiwan, has paid to CVI) out of the total sales amount
- The tax authority determined the arm's length price by averaging the percentage of royalty paid in comparable transactions proposed by the Company and those of the following domestic comparable transactions:
  - The percentage of royalty that domestic movie distributors Woo-jin Film (movie) and SKC (video) have paid to unrelated movie distributors
- The tax authority determined a portion that exceeds comparables' royalty rates as non-deductible.

4. Key issues

1) Comparability of the companies selected by the tax authority

- **Company**
  - Transactions of Woo-jin film and SKC have no comparability with the Company's transactions with foreign related parties, thus both should not be considered as comparables
- **Tax authority**
  - A percentage of royalties paid to Fan Asia (movie) and King Video (video) from the comparables proposed by the Company do not reflect the geographical and cultural differences from Hong Kong and Taiwan, thus domestic comparables (Woo-jin and SKC) should be added to comparables

I. Movie/Video Industry

4. Key issues

1) Comparability of the companies selected by the tax authority (Cont'd)

- **Court decision**
  - **Movie**: a percentage of royalty for Woo-jin and those of the Company are not comparable as per the following points:
    1) **Quality of the movie**: movies Woo-jin has imported/distributed are only 1/2.7 of the Company's in terms of average number of audiences and average profit
    2) **Payment method**: the Company implements regular royalty payment method, whereas Woo-jin pays the set amount of royalty based on a prearranged agreement regardless of the performance results
  - **Video**: No material difference in quality exists between videos the Company has imported/distributed and those SKC has imported/distributed. Further, even though a slight difference exists in the payment method of box office profit and royalty, this minor difference could be due to geographical and economical conditions which affect the determination of royalty. Therefore, a high level of comparability exists.

4. Key issues

2) Method in determining the arm's length price

- **Company**
  - As comparable transactions also include other foreign transactions with Israel and Portugal, it is deemed appropriate to use the inter-quartile range in determining the arm's length price
- **Court decision**
  - If there is a transaction conducted under the same conditions as the controlled transaction or does not require adjustment, it is sufficient to compute the arm's length price using this transaction's figures – no need to add other data
  - Provided that the tax authority has used the requisite amount of effort to collect data in determining the arm's length price range and the result is deemed rational, then the taxpayer has the burden to prove that the price it has used in inter-company transactions falls within that range
  - Furthermore, it is not appropriate to consider the arm's length price determined by the tax authority as a violation of law only based on the ground that the arm's length price proposed by the taxpayer is more rational

5. Implication

- In case a difference (e.g., transaction condition) exists between the controlled transaction and comparable transaction based on the CUP method, 'rationality' was proposed as a standard to adjust such difference
- The following has to be taken into consideration in selecting comparable transactions of the movie/video industry: (1) quality of the movie/video (2) payment method of royalties (3) box-office record (4) geographic condition and (5) economic condition, etc.
- If it is considered that the tax authority has put its best effort to collect data in determining the arm's length price and the result is deemed rational, then the taxpayer has the burden to prove that the arm's length range can be obtained using multiple comparables and that the price it has used for inter-company transactions falls within that range.
- It is inappropriate to consider that the arm's length price determined by the tax authority as violation of law only based on a ground that the arm's length price proposed by the taxpayer is more rational

II. Pharmaceutical

1. Understanding of the industry
2. Background
3. TP adjustment by the tax authority
4. Key issues
5. Implication

1. Understanding of the industry

1) Characteristics of the pharmaceutical industry

- High risk- high development expense, long development period, and difficult to predict the success rate
- Shortened period for competitors' introduction of new products
- Profit generation strategy
  a. Focus on development of a new medicine →excessive investment, high risk
  b. Exploit the niche market (e.g., customizable new medicine)
  c. Capture market opportunity via modeling (fast follower)

2) Generic market

- Generic : medicine which offers the same function and effect as new medicine
- Approval condition: equality, safety, effectiveness
- Same approval condition as with the development of new medicine → low effect of cost reduction

2. Background

1) Basic background

- Glaxosmithkline Inc. (“Glaxo Canada”) is a 100% owned subsidiary of Glaxo Group
- Glaxo Group is a 100% owned subsidiary of Glaxo Holdings PLC
- Glaxo Holdings is a global pharmaceutical company which discovers, develops and manufactures medical supplies and then sells them globally
- Sales of medical supplies are conducted through subsidiaries of Glaxo Group or local distributors
- Ranitidine is an Active Pharmaceutical Ingredient (“API”) and the Company sells Zantac, a treatment medicine for ulcers, in Canada
- Apotex Inc, Novopharm Ltd. (“Generic”) is a company which manufactures medical supplies after paying royalties to a party holding the patent, and was selling Ranitidine in Canada at the time
- Sales of Ranitidine in Glaxo Europe was conducted through third party licensees in many countries
- Key issue is the arm’s length nature of the price at which Glaxo Canada purchased Ranitidine from its related parties for 1990~1993

2. Background

2) Facts

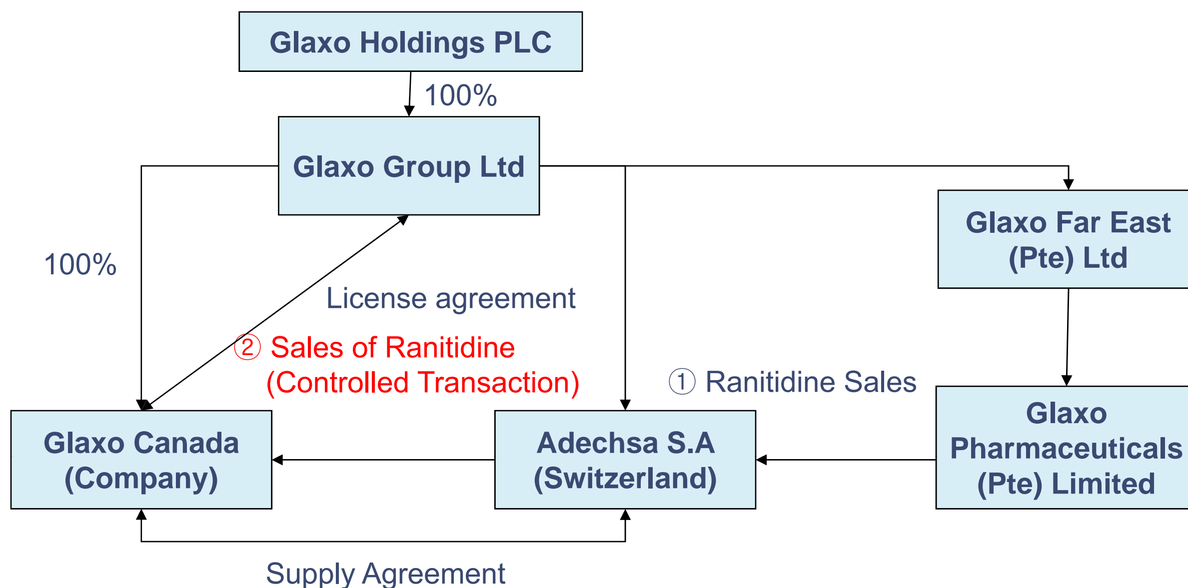
- Glaxo Pharmaceuticals (Pte) Limited is a Singapore-based entity which initially manufactures Ranitidine
- Adechsa S.A is a Switzerland-based clearing company of Glaxo
- Glaxo Pharmaceuticals (Pte) Limited sells Ranitidine to Adechsa S.A, and Glaxo Canada purchases from Adechsa to sell in Canada
- Glaxo Canada’s purchase prices from Adechsa and generic companies’ purchase prices from third parties during the tested period are as follows:

(Unit: USD)

Year	Purchase Price	
	Glaxo Canada	Generic Companies
1990	1,512 /kg	292 ~ 304 /kg
1991	1,575/kg	244 ~289 /kg
1992	1,635/kg	220 ~ 253 /kg
1993	1,651/kg	194 ~ 248 /kg

2. Background

3) Transaction structure



3. TP adjustment by the tax authority

- The tax authority selected generic companies' purchases of Ranitidine from third parties as comparable transactions in determining Glaxo Canada's income for the tested period
- As the price at which the Company has purchased Ranitidine from its related parties exceeded the highest price among the generic companies' purchase prices, the tax authority adjusted Glaxo Canada's purchase prices by the amount of which exceeded the prices applied to comparable transactions in calculating its taxable income

TP adjustment = (Company's purchase price – Purchase price in comparable transaction) X Transaction volume

4. Key issues

1) Selection of TPM and comparable transactions

Category	Company's position	Tax authority's position
TPM	Primary method: CUP Secondary method: TNM	Primary method: CUP Secondary method: CP
Comparable Transaction	Purchase of Ranitidine by Glaxo's licensee distributors in European Region	Purchase of Ranitidine by generic companies
Reason	- Glaxo group performs strict quality control by meeting internal production quality standards - As such, Glaxo's products are of a higher quality than generic products and comparability does not exist	- European Licensees are not comparable due to regional differences - As Glaxo pays separate promotion support and subsidy to licensees, comparability is low - Difference exists as European Licensees retain 60% of the gross profit based on the contracts with Glaxo

4. Key issues

2) Issues in applying the CUP method

Category	Company's position	Tax authority's position
Consideration of License Contract	- Should take both supply contract and license contract into consideration	- Each contract is separate and should be based on the supply contract
Reasonable Circumstance	- Comparability does not exist between the Company's transactions and generic company's transactions due to different business circumstances	- Business circumstance has no relevance with a TP analysis and does not affect determination of the appropriate price
Quality and Production Control Standard	- Glaxo Group products offer better quality due to its strict quality and production control	- Quality and production control do not have much effect on product quality - No difference exists between the Company's products and generic products

→ The Court has decided in favor of the tax authority

4. Key issues

3) TP adjustment by the court

- In relation to Glaxo Canada's purchase transactions of Ranitidine, the Tax Court determined purchase prices of generic companies (i.e., comparable transactions) to be the arm's length price (May 2008).
- TP adjustment amount was computed to be the difference between Glaxo Canada's purchase prices and generic companies' purchase prices.

  - Though there were differences between Ranitidine purchased by Glaxo Canada and Ranitidine purchased by generic companies, there was not sufficient proof that quality control contributed to the differences and, as such, no adjustment was made.

- The Federal Court of Appeal (**Appeal Court) overturned the Tax Court's decision** (July 2010). → **Sending the case back to the Tax Court** for a redetermination of the appropriate arm's-length price
- Appeal Court held that the License Agreement should be considered conjointly with the cost of the ranitidine.
- Appeal Court acknowledged that the significant brand power associated to the drug affords the Glaxo Group a great deal of bargaining power when negotiating transfer pricing transaction.

5. Implication

- In applying the CUP method, this case demonstrated the technical application of methods highlighted in the OECD guidelines such as '**Economic Comparability**', '**Comparability of Commodities**', and '**Contract Conditions**'
- In evaluating the arm's length nature of purchase transactions, **a comprehensive examination of all relevant facts as well as the entirety of taxpayer's business model must be under**taken in order to determine a reliable transfer price.

Thank you !