What Is Transfer Pricing?

Transfer price
= the price at which goods, services, financing or intellectual property are transferred between connected parties

Why Is Transfer Pricing Important?

Business Reasons
- Multinationals need to understand how profit is earned in order to make valid business decisions
Why Is Transfer Pricing Important?

**Tax Reasons**
- Tax authorities want to ensure that the correct profit is attributed to the economic activity in their jurisdiction in order to be able to collect the correct amount of tax.
- In the UK, on signing a Corporation Tax Self Assessment (CTSA) Return a company is implicitly saying that it has considered transfer pricing and the level of its taxable profits reported in the Return is an arm’s length amount.

Legal Framework / Guidance

... is provided by:
- International consensus (OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations)
- Domestic tax legislation (e.g., Schedule 28AA ICTA 1988)

Gentlemen’s Club

Organisation for Economic Co-operation and Development
- Formed to administer Marshall Plan
- Takes lead in facilitating international development
- Recognises tax as a potential barrier to international trade
- Takes responsibility for Model Tax Convention
  - a ‘pro forma’ tax treaty for countries to use to reduce double taxation
  - encourages members and non-members to follow
- The OECD’s Transfer Pricing Guidelines ... is not legislation!
  - but it does set out the commonly-agreed principles
Development Of The Arm’s Length Principle

OECD view of transfer pricing is based on the arm’s length principle

Article 9 of OECD Model Tax Convention:
Where...
“conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from whose which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly”

OECD Approved Transfer Pricing Methods

Traditional transaction methods
- Comparable uncontrolled price method (CUP)
- Cost plus method (CPLM)
- Resale price method (RPM)

Transactional profit methods
- Profit split method (PSM)
  - Residual
  - Contribution
- Transactional net margin method (TNMM)

NB: CUP method preferred by OECD and most tax authorities, including UK

UK Transfer Pricing Legislation

New legislation applies to accounting periods which ended on or after 1 July 1999, onwards
- The onus is now on the taxpayer to demonstrate that an arm’s length level of profits has been achieved
- Documentation that sets out how the taxpayer satisfied himself that this is the case, or establishes the adjustment required to increase (not decrease!) taxable profits to an arm’s length result.
- Penalties for insufficient documentation

Amended:
- 2004 to remove UK-UK exemption and incorporate thin cap legislation
- 2005 to introduce anti-avoidance legislation with regard to financing
**Key components of TP review & documentation**

Information Gathering: interviews, company & market data collection

Functional Analysis: Formal description of the taxpayer & economic relationship with the rest of the group

Economic Analysis: Formal analysis of prices/profits

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**Preparing transfer pricing documentation**

Requires a multi-disciplinary team comprising:

- Tax professionals (often ex-Revenue)
- Transfer Pricing economists
- Actuaries

What they do:

- Interface between taxpayer and tax official
- Advocate and negotiate
- Provide knowledge of tax concepts and processes
- Provide detailed knowledge of relevant tax provisions

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**Functional Analysis**

This section gives:

- an overview of the group
- A mapping of the intra group arrangements (cross-border transactions)
- Identifies the key value drivers, assets, and risks in the business, what legal entity they are situated in, and in which tax jurisdiction

*This sets the scene for choosing the correct OECD transfer pricing method and its application in the Economic Analysis section*
In reality, in a group reinsurer …

Prices may be set using simple rules which do not reflect either functions performed or risks assumed
Prices are often set according to corporate profit maximisation goals
  - Business unit performance measurement
  - Management incentive compensation
  - Supply management
  - Cash management
Prices and profits that once reflected costs or market forces may no longer do so
Prices may even be set so as to minimise the overall corporate tax burden

Intra Group Arrangements ‘caught’ by TP

MegaRisk Ltd (Bermuda)

Quota share reinsurance

Investment management

Claims handling functions

Claims and expenses payments

UK Branch

Economic Analysis

In practice two ways that are generally used to evaluate Intra-group reinsurance arrangements:

- Comparable uncontrolled price analysis (CUP)
- Transactional net margin method (TNNM)
CUP Approach

- Favoured approach by the UK Tax Authorities
- Establish if a comparable transaction exists in the marketplace between unrelated parties
- If not, does the ceding company underwrite open-market treaty business comparable to the business under review?
- May be appropriate to use cedant’s reinsurance pricing model to establish a comparable price

TNMM Approach

- CUP approach is not always possible
- Most suitable alternative – TNMM approach
- TNMM in a reinsurance context requires an actuarial approach to modelling the emergence of profits and the run-off of capital supporting the block of business under review – from the ceding office’s perspective

High Level TNMM Approach for Quota Shares

- Assume that cedant will not enter into a contract unless it can earn its target net rate of return
- Calculate net present value of future profits emerging from cedant’s book of business before and after proposed reinsurance
- Equate discounted profits/losses before and after the quota share to derive the theoretical ceding commission.
- If, taking one year with another, the actual commission is greater than or equal to the theoretical commission then the tax authorities are not disadvantaged by the arrangements and we consider the pricing to be an “arm’s length” transaction
Actuarial Model – Key Inputs & Assumptions

- Premium income
- Cost of claims
- Reinsurances acting prior to quota share
- Payment patterns of premiums and claims
- Acquisition costs and other expenses
- Return on investments

Capital Considerations

- Provides for risks associated with writing the business
  - Underwriting and reserving risks
  - Credit and asset risks
  - Operational risks
- Reflects desired security rating
- Consistency with the assumed discount rate.

Choice of Discount Rate

- Required return over the underwriting cycle
- Reflects risks inherent in the actual business
- Consistent with cedant’s pricing of third party risks
- Consistent with the definition of capital used
Information Sources

- The price must be calculated with reference to data available at the time of writing the contract
- Business plans at the time the contract is agreed
- Company capital models or appropriate industry models
- Reinsurance treaties
- Internal run-off patterns from reserving reports
- Discussions with company

Other supporting documentation

- Intra group contracts (reflecting terms that would have been agreed at arm’s length)
- Books and records to show that the transfer pricing policy was actually implemented correctly, e.g., right amount of costs identified when charging on a “cost plus” basis
- 3rd party market analysis commentary to illustrate the state of the industry sector, position of the taxpayer in the industry
- Documentation should be updated as often as required to reflect the position of the group in connection with the year of the tax return being filed
- Reflect the “facts and circumstances” and knowledge available to the parties to the intra group arrangement at the time of the transaction (no foresight)

Key messages

- Onus on taxpayer to ensure transfer pricing is correct and supporting documentation is in place
  - Has been for more than 5 years – no excuses!
- Transfer pricing is a key earner for HMRC
  - KPMG Tax analysis of HMRC letters received last year – transfer pricing the number 1 question asked.
  - 20% of HMRC’s total ‘take’ from audits on international tax matters
  - HMRC’s highest yield:cost ratio – therefore high audit risk?
- Action points
  - Review intra group transactions, especially ceding commissions
  - Review documentation that supports the pricing
  - Fill in the gaps – consider an economic study
  - Do it NOW! Avoid penalties and costly adjustments