TRANSFER PRICING ANALYSIS: MORE THAN PROFITABILITY COMPARISON

By Dr Markus Brem

Transfer pricing between related parties requires sound arm's length analyses to pass the tax audit. The analysis seems of particular importance in such cases where the operating margin of related parties abroad is understood as an excess profitability with values exceeding the somewhat 10% threshold of EBIT% profitability. Often, the analysis pursued is too short-sighted if the arm's length nature of the transfer price is only considered at the level of the profitability of the related-party entity. A couple of reasons can be identified for such limited analytical perspective.

Among others, the related-party entity contract manufacturing ("CM") – be it identified as the "tested party unit" of the particular analysis case – could also be involved in third-party business. This could imply that the CM's EBIT%-margin is an inadequate profit level indicator for the arm's length test as the entity's margin is not only determined by transfer pricing issues but also by third-party success and failure. Likewise, CM may have related-party transactions with different parties (say, A, B, C) within the multinational group. Again, this triggers question on the cause-and-effect logic between the transfer price of the transaction of CM with A, on the one hand, and the transfer price between CM and B, or CM and C, on the other hand.

The analytical challenge applies to each of the OECD test models proposed by the OECD Transfer Pricing Guidelines. In many practitioner cases, transfer pricing methods of the OECD are discussed, in theory, to be applied "transaction-based" but, in practice, they seem to be abused to assess the entity's operating margin. Experience from hundreds of cases tells us that this deficient application of the "right transfer pricing method" is seen in the case of the Comparable Uncontrolled Price Method, the Cost-Plus Method, the Resale Minus, the Transactional Net Margin Method, and the Transactional Residual Profit Split Method.

Controversy in court cases

In a recent case which reached the Federal Tax Court of Germany,[1] such analysis problem was part of the controversy. In a nutshell, the case can be presented as follows: the German entity, DE, performing the headquarters function together with manufacturing and sales function in the automotive suppliers industry (Tier 3 supplier) has been engaging its related-party manufacturer abroad (CM) to supply pre-manufactured products resold by DE to its German customers. The transfer prices for the delivery from CM to DE were set based on an internal cost-plus calculation. In addition, CM also sold some output of its manufacturing function to its own customers domestically.

Throughout the audit period, the EBIT% profitability of CM was much about the fictious 10% threshold being understood as an "excess profitability" allegedly caused by exorbitant transfer prices paid by DE to CM. As the case is a small-taxpayer-case under the definition of the German documentation provision, a transfer pricing documentation package was not requested to be submitted at the start of the tax audit. And so, the mess took its course throughout the tax audit process and the lower court procedures.

In the tax audit of DE, the German tax auditor presumed that the transfer price being computed by means of that internal cost-plus model applied to the price setting decision was chosen incorrectly. Arm's length data were insufficiently implemented at the time of price setting. The tax audit considered the net markup on top of full costs with a value of 13% as non-arm's length. Even worse, de facto, the entity, CM, realised in the audit period an EBIT% margin of 17%.

Indeed, at a first glance such fact pattern seems attractive for the tax audit to assess not at arm's length and, consequently, to adjust income to the favour of the German tax revenues. Also, this first impression can be even reinforced by means of traditional benchmarking approaches with CM as the tested party. Here, the interquartile statistics of comparable companies rarely is outside the one-digit range of EBIT% margins for which reason the EBIT% margin of 17% of CM does appear too high – hence transfer pricing be not arm's length in the meaning of the auditors. Is it really that simple?

Turning the perspective along the value chain

However, the arm's length appraisal may give the opportunity to reveal a quite different picture from the perspective of DE. In this particular case, the amount of profit allocated to CM is less than one-fifth of the total profit

1. BFH Court case I R 54/19 [www.bundesfinanzhof.de/de/anhaengige-verfahren/aktuelle-verfahren/detail/STAH190100054]

of the two-entity group while the amount of manufacturing costs at CM is about three-fifths of such products sold to the customer. From this follows the larger part of the value chain, in particular the higher portion of profit, and the larger relative profitability (operating margin) is at the side of DE. Without the inbound purchases from CM, DE would have either resulted in lower profits, or even a loss situation. Let aside the possibilities of not meeting the market demands claiming low customer prices, which, for DE, only the CM model in a low-cost jurisdiction was likely to ensure – compared to the high labour costs in Germany.

Regardless of the profit level indicators chosen (net markup, net margin, gross markup, gross margin), each of the benchmarking models we submitted during the proceedings on appeal on questions of law at the Federal Tax Court have shown the same result: the profitability ratios of CM are slightly above, or within the interquartile ranges, while those of DE are higher, and always above the respective interquartile ranges.

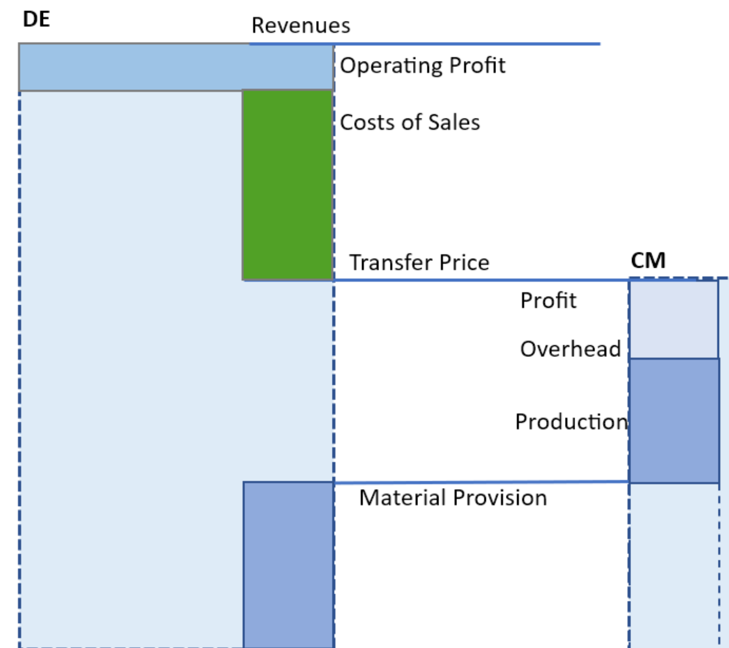
What to learn from this "simple case" of a multi-layer transfer pricing analysis

From this court case follows that transfer pricing analysis should be construed on the basis of various views along the value chain if, at the first instance, an excess profitability is presumed at either side. Such multi-layer analysis brings the opportunity to result more robust arm's length statements – compared with an analysis approach where only one single profitability ratio is deployed. In other words, deliver a multi-layer model of arm's length test to submit a robust arm's length test.

Even more generally, we claim that each OECD Transfer Pricing Method enables the analyst to answer this very question on the arm's length character of transfer pricing models in the same manner: is the transfer price at arm's length – or not. Basically, we make use of different transfer pricing methods to look from different perspectives and/or make use of data available.

What decision to expect from the Federal Tax Court

Although, the court case is not yet sentenced and proclaimed, there is an indication that the First Senate of the Federal Tax Court Germany is likely to return the case to the lower court (*Finanzgericht*). The judges of the lower court will have to collect further evidence on the nature and arm's length character of the transfer pricing fact pattern. Basically, we expect that the lower court will integrate additional arm's length data focusing from different angles of the value chain. This, however, would mean looking at the profitability of the transactional recipient (i.e. DE), and also to subtract profit from the amount of EBIT which was not caused by CM's deliveries to DE but by its third-party business in the local market.



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