

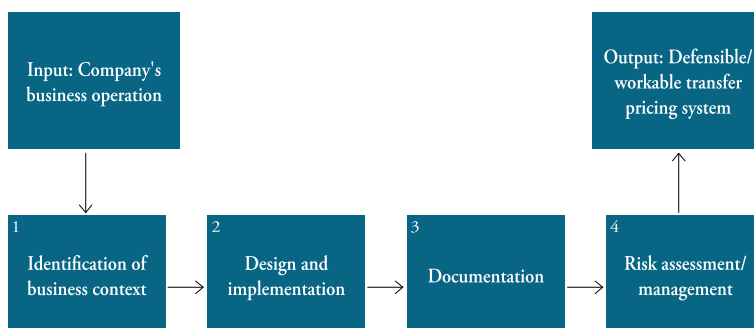
Designing and Implementing a Transfer Pricing System

Undoubtedly the introduction of transfer pricing documentation requirements and detailed tax return disclosures has dominated the transfer pricing discussion in China recently, and this will be discussed in detail in chapter titled [Transfer Pricing Disclosures and Documentation](#). However, what is often overlooked is the need to design and implement the optimal transfer pricing system well ahead of focusing on documentation. Giving appropriate time for this early in the business cycle helps to ensure that the transfer pricing system is the most tax effective, consistent with the business model and commercial objectives, and documented efficiently. It will also help mitigate and manage transfer pricing risk exposure.

With this in mind, this chapter is focused on the design of an optimal transfer pricing system as well as selecting and applying an appropriate transfer pricing methodology.

The Transfer Pricing Associates group has applied a framework referred to as the Transfer Pricing Process. The Transfer Pricing Process addresses transfer pricing and the business risks around it as a business process by allowing the MNC to link how it operates its business to a transfer pricing system in a simple and logical way.

The process is captured in the diagram below.



Each of the four boxes in the transfer pricing process is discussed in more detail in the following sections.

Box 1: Identify the Relevant Business Context

Every industry is different and even within the same industry, each company has a very different strategy, internal organization, brand, and objectives as well as function, asset and risk profile.

Identifying this business context as early as possible assists in closing the gap between the business reality and the perspective of the various tax authorities. This process combines internal and external sources of information to draw a concise picture of the MNC's business, the industry in which it operates and the key functions of each of the group companies.

Given that it is vital for tax authorities to acquire a solid understanding of the business of an MNC before starting to investigate and scrutinise its transfer pricing system, Box 1 is a crucial step in the transfer pricing process.

Broadly speaking, Box 1 consists of the industry analysis and functional analysis, each of which is discussed below.

Industry Analysis

The OECD Transfer Pricing Guidelines as well as the transfer pricing regulations of all countries, including China, recognize that external economic factors can impact the transfer pricing between related entities. For this reason, the guidelines suggest that it is useful to include in transfer pricing documentation an analysis of the taxpayer's industry. Specifically, an industry analysis should include:

- Macroeconomic factors impacting the industry
- Description of the key characteristics of the industry, such as:
 - growth rates (historical and forecast)
 - barriers to entry
 - success factors
 - regulatory framework
 - level of competition
 - key players and market shares.
- Market forecasts and anticipated impact on companies in the industry

For example, the global economic crisis in 2008 and 2009 and performance of the macro economy would go a long way towards explaining the low profitability of an entity during this period; that is, to demonstrate that reasons other than non-arm's length transfer pricing are responsible for the profitability of the company.

From a tax authority perspective, industry trends help them identify suitable cases for a transfer pricing risk review. Also, once the tax authority has carried out a transfer pricing review or audit in respect of one taxpayer in a particular industry, it has often been the case that the tax authority will use the industry knowledge acquired from that review in order to carry out reviews and audits of other players in the same industry.

The types of information contained within an industry analysis are available in external resources such as:

- analyst reports
- industry research reports
- annual reports of major players in the industry
- general media and other information typically available on the internet.

Functional Analysis

The other key aspect of Box 1 of the Transfer Pricing Process is the functional analysis. The functional analysis is an overview of the key activities performed by the entity, the assets used and risks borne. It provides a perspective on the role of the entity in the total value chain of the group.

Each business is unique in terms of the combination of functions, assets and risks. The following table gives an indication, as an example only, of the types of functions to be included in a functional analysis, as well as the associated assets and risks.

Functions	Assets	Risks
Management	Office equipment, know-how	Market risk
R&D	Patents	R&D risk
Procurement	Supplier lists	Inventory risk
Manufacturing	Know-how, factory	Capacity risk, product liability risk
Marketing	Brand	Market risk, marketing risk
Sales	Brand, customer lists	Market risk, credit risk
Logistics	Warehouse	Freight risk, inventory risk
Finance and administration	Office equipment	Foreign exchange risk

So what is the best way to complete the functional analysis? Speaking to key personnel to understand their key roles and responsibilities and how each division interacts with one another within the company (often referred to by practitioners as “the functional analysis interview”) also allows the MNC to gain a better insight to its business, the industry and key responsibilities of different companies in the group. In most cases, the head of each business division can provide:

- an overview of the value chain
- an explanation of their roles and responsibilities and interaction with other functions and group entities

- decision making processes within the group and risks borne
- relevant industry information and trends as they impact the company

The functional analysis is an aspect of a transfer pricing report that companies can potentially perform themselves with little or minimal support from an advisor, assuming the company has internal resources and sufficient expertise available. If an advisor is engaged, the critical point is to ensure that at least one internal person is nominated to coordinate the process and be actively involved. This ensures that the project runs efficiently which saves costs but, perhaps even more importantly, enables a knowledge transfer from the advisor to the company's internal team. This intangible will ensure that the process can be streamlined in the future, and more importantly that the report is implemented as intended.

Box 2: Design and Implement the Transfer Pricing System

The design of a transfer pricing system determines the appropriate return for each of the group companies as well as ensures the alignment of the transfer pricing system with the business model and commercial objectives.

The roles and responsibilities captured for each of the group entities (through the functional analysis) address, from a management accounting perspective, the parameters for determining the success or failure of performing each activity. From a tax perspective, the same process enables the allocation of the operating margin to each of the group companies in the value chain.

In the design of a transfer pricing system, the concept of “responsibility centers” is useful. The purpose of this concept is to link the business reality and the way the MNC does business to the appropriate method of compensation for each group company.

The concept of responsibility centers looks at transfer pricing as a steering and controlling instrument, which is being used by the MNC to ensure that each of the group companies focus on their own roles and responsibilities.

Each set of attributes reflecting a certain role and responsibility profile can, more or less, be matched with one of the following labels:

- Investment center
- Profit center
- Cost center
- Revenue center
- Expense center¹

In the following section, a practical illustration is provided of how these concepts can be applied to various common operating structures in China in respect of

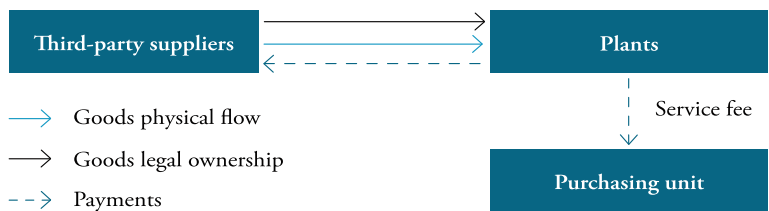
¹ Although often referred to interchangeably, expense centers differ from cost centers in that the activities of the former tend to be core in nature while the activities of the latter tend to be non-core in nature.

procurement, manufacturing and distribution operations (note: this classification is important as it greatly simplifies the transfer pricing methodology selection process). Appendix 1 contains the Manual for Responsibility Centers.

Procurement

Option 1—Services Model: Cost Center

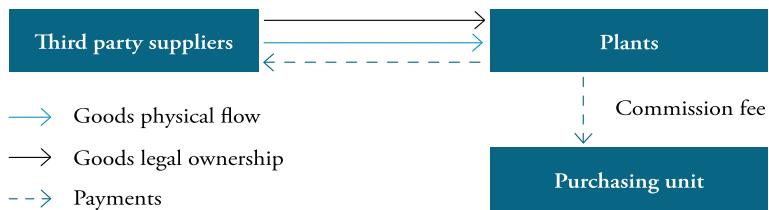
Under a service model, the purchasing unit performs only services of a coordinating and otherwise supportive nature. The purchasing unit does not take ownership of the materials and assumes a low level of risks.



The responsibility profile of the purchasing unit is a cost center, and the service fee is determined using the cost plus method.

Option 2—Commission Agent Model: Revenue Center

Under a commission agent model, the purchasing company develops activities with some value added, basically related to market intelligence. Like the service model, the purchasing company does not take ownership of the inventory and assumes a low level of risk. The responsibility profile of the purchasing unit is usually a revenue center, and the transfer pricing policy is based on a commission fee calculated as a percentage of the purchase value.

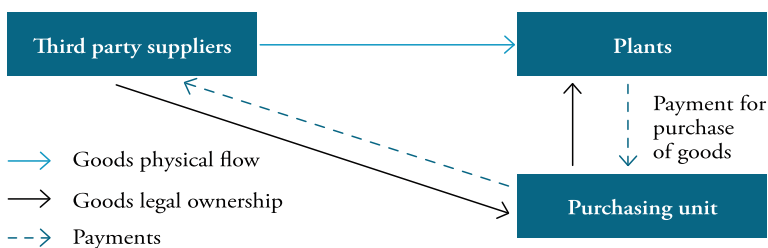


Under this option it is also possible that some volume discounts or other forms of purchasing-related bonuses will be recognized by the purchasing company. The

purchasing company will need to allocate these amounts to the entities proportionately for which the purchases are being made, at appropriate intervals.

Option 3—Buy/Sell Model

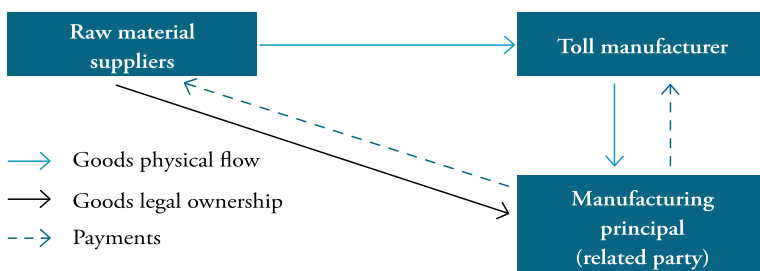
Under a buy/sell model, the purchasing unit develops activities with a high added value. Among the activities performed are market intelligence, inventory and manufacturing management, quality control, finance and logistics. The purchasing company takes ownership of the materials purchased and usually assumes inventory, exchange and logistics risks. The responsibility profile of the purchasing unit is usually a profit center, and the transfer pricing policy is designed with reference to savings achieved.



Manufacturing

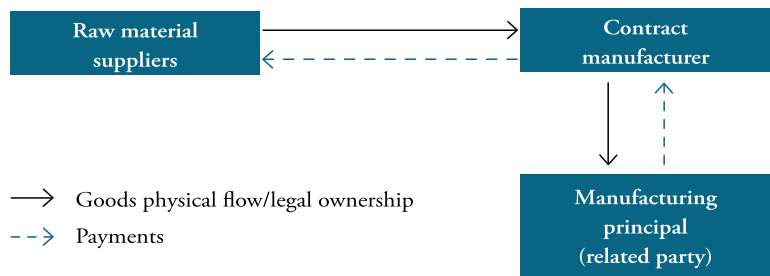
Option 1—Toll Manufacturer: Cost Center

Under a toll manufacturing model, the toll manufacturer performs a processing function on behalf of a related party principal and does not take title to raw materials. It holds only minimal intangibles related to the manufacturing processes and is rewarded through a toll manufacturing fee calculated as a mark-up on processing costs, which is paid by the manufacturing principal. Such entities are classified as cost centers.



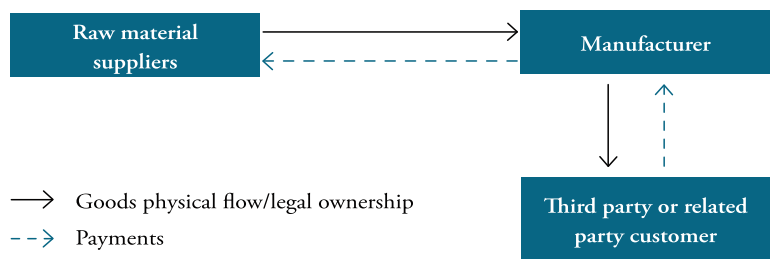
Option 2—Contract Manufacturer: Cost Center

The contract manufacturing model is similar to the toll manufacturer, except that the contract manufacturer does take title to raw materials and may be involved in procurement of such materials. Finished goods are sold to the manufacturing principal and priced to enable the contract manufacturer to earn an arm’s length mark-up on total costs. Contract manufacturers are also classified as cost centers.



Option 3—Fully Fledged Manufacturer: Profit Center

The fully fledged manufacturer is responsible for sourcing materials, undertaking production and potentially selling to third parties on its own risk as well as to related party distributors. It bears a range of risks related to pricing and markets and owns intangibles related to the manufacturing process, products and potentially brands. Such entities are classified as profit centers.

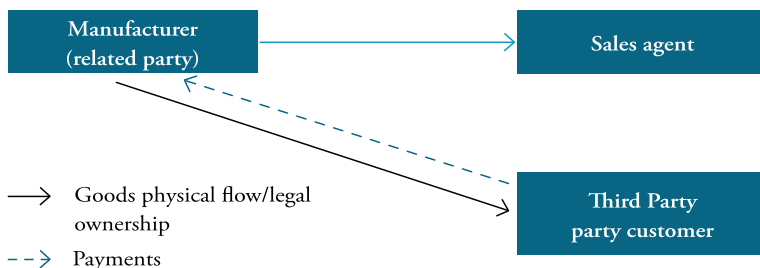


Distribution

Option 1—Sales Representative/Sales Agent: Cost/Revenue Center

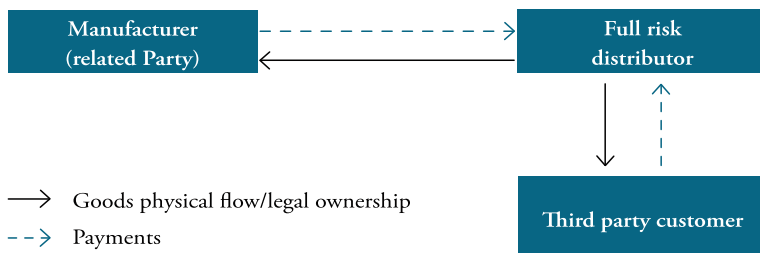
A sales representative or sales agent is responsible for understanding the local market, identifying customers and negotiating sales. Such entities do not take title to finished goods and the legal and typically physical flow is from the related party

entity. They therefore bear no risk on inventory and receivables but may bear some market risk. They are either remunerated on a cost-plus basis (cost center) or on a commission based on notional sales generated (revenue center).



Option 2—Full Risk Distributor: Profit Center

At the other end of the distributor spectrum is the full risk distributor. Such entities purchase from related party manufacturers and are fully responsible for holding inventory, logistics, local marketing and sales. They bear market, inventory, credit and other risks consistent with these functions. In the responsibility center matrix they are classified as profit centers.



A limited risk distributor has the same transaction and goods flow as a full risk distributor, however it generally bears a more limited range of market, inventory and other risks. Such entities are classified as revenue centers.

From the examples above, it should be noted that the classification of responsibility centers is based on the underlying economic reality with strong reference to the functions, assets and risks assumed by the entity. The use of the responsibility center concept provides a clear and logical framework for analysis and overcomes the confusion from the typical labels used in transfer pricing such as “limited risk distributor,” “commissionaire” and “contract R&D provider” which typically do not explain all business models and their underlying economic reality.

Once the multinational group’s business process has been analyzed and the various group companies have been classified in this way, the transfer pricing policy as well as the choice of transfer pricing methodology becomes clear.

Box 3: Documentation of the Transfer Pricing System

Box 3 involves the preparation of transfer pricing documentation, which broadly consists of the following elements:

- Industry analysis—to place the functional analysis in the context of the industry in which the multinational group operates
- Functional analysis—description of the key transactions, functions, assets and risks of the entity under review, to enable the classification of the entity and guide the selection of transfer pricing methodology
- Design of the system, and selection of the most appropriate transfer pricing methodology
- Benchmarking using the most appropriate methodology—normally involving searches of financial databases

Preparation of transfer pricing documentation in the China context is discussed in some detail in chapter titled [Transfer Pricing Disclosures and Documentation](#). Below, one specific type of documentation—the transfer pricing master file—is discussed in detail.

The Transfer Pricing Master File

Many MNCs adopt a coordinated approach to the preparation of transfer pricing documentation since this is easier to administer and considerably more cost-efficient in practice than preparing documentation on a local country-by-country basis.

The coordinated approach involves creating a “master file” that contains the “core” elements of transfer pricing documentation that are generally required by all tax authorities around the world as part of their transfer pricing regulations.

The origins of the master file were in Europe. In 2002, the EU Joint Transfer Pricing Forum (JTPF), was set up and in 2003 the OECD requested the JTPF to address regional transfer pricing documentation requirements.

According to the JTPF, the preparation of a large number of separate and unique sets of transfer pricing documentation on a per-country basis, as a consequence of different documentation requirements within the EU, is not a cost effective proposition. EU member states argued that they often are unable to examine transfer prices due to noncompliance by taxpayers with documentation requirements.

In practice a master file for Europe and even globally has proven to be a feasible alternative to more traditional country-by-country regulations regarding transfer pricing documentation. In the case of China, if an MNC has multiple entities throughout China, it is possible to apply the master file concept to create one central report which can then be efficiently converted into entity-specific documentation if needed.

Once the core documentation has been prepared, it generally satisfies 70–80% of the requirements of each of the tax authorities in the countries in which the

multinational does business. If a particular country requires transfer pricing documentation prepared specifically in respect of the local entity, this can be done easily and cost effectively by utilizing the information and documentation already prepared as part of the master file, with some amendments to render it specific to the local entity, and perhaps with—some additional economic analysis.

The key benefits for multinationals in adopting a master file approach:

- Ensures a consistent approach to the classification of group companies, selection of methodologies and economic analysis
- Considerably ease the maintenance and updating on an ongoing basis—multinationals are better able to take control, and stay in control, of their transfer pricing systems
- Enhance efficiency since multinationals only need to prepare specific local documentation where the regulations require it or in the event of a high transfer pricing risk

Transfer Pricing Software

In recent years an increasing tendency has emerged amongst large MNCs to use software products to create transfer pricing documentation packages. The automation of the documentation process will become increasingly important as the compliance burden for MNCs grows, as more countries introduce mandatory documentation requirements.

It is important to recognize that the investment in such software would typically be most viable for larger MNCs with multiple entities in China and globally as well as the required in-house resources to implement and coordinate the relevant input into the software. Software can create considerable efficiencies in transfer pricing compliance and should be seen as one component of the transfer pricing process.

Transfer Pricing Methods

The following are the recognized transfer pricing methods in the OECD Transfer Pricing Guidelines as well as in China:

- Comparable Uncontrolled Price Method
- Resale Price Method
- Cost-plus Method
- Transactional Net Margin Method
- Profit Split Method
- Other appropriate methods that comply with the arm's length principle

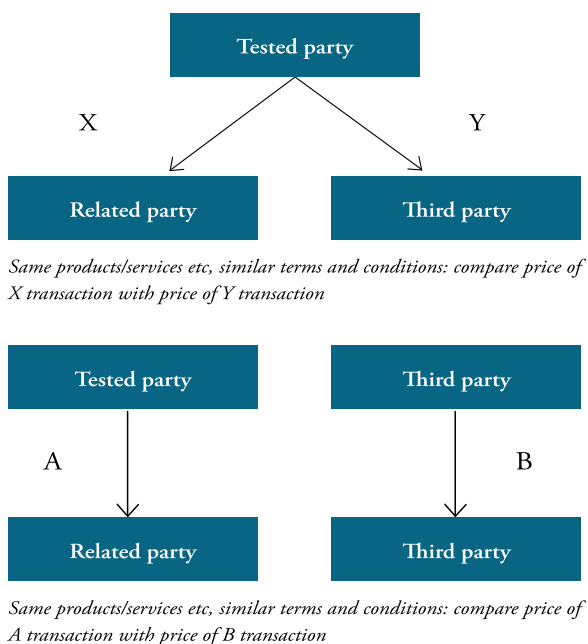
The selection of an appropriate transfer pricing method should be guided by the level of comparability of data used and the reliability of the results.

The following are descriptions of the accepted transfer pricing methods.

Comparable Uncontrolled Price Method (CUP)

The CUP method takes the prices that are charged by arm's length parties or to non-related parties in conducting the same or similar transactions with the related party transactions as the arm's length price. The CUP method is potentially applicable to all types of related party transactions. The CUP method requires a high level of comparability and if available would generally provide the best benchmark of an arm's length price for a related party transaction. However, in practice, it is rare to find a reliable CUP outside of commodity or financial services products with a publicly listed price.

The CUP can either be applied on an internal or external basis. Each is illustrated below:



When considering other methods, which require an analysis of gross margins or net margins, special attention should be paid to the differences of functions and risks, contractual terms and other factors that might impact the profit margin of comparable uncontrolled transactions, such as manufacturing, processing, installing and testing functions, market and foreign exchange risk, value and useful life of machinery and equipment, use and value of intangible properties, business experiences, accounting treatment, and management efficiency. If significant differences exist between the related party transaction and unrelated party transaction, it is essential to consider whether an adjustment is feasible and if not, consider the use of another method.

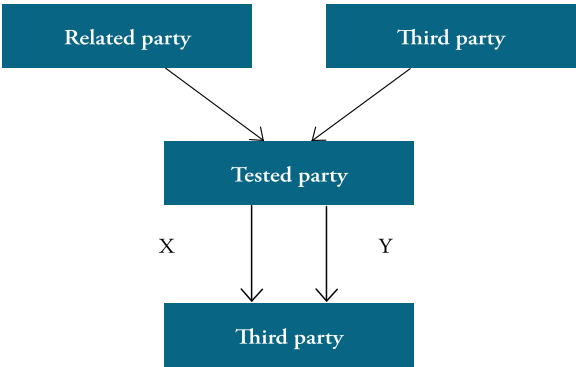
Resale Price Method

The resale price method is relevant to goods rather than services, where the arm’s length price for the goods purchased from a related party is determined by deducting the gross profit of a comparable uncontrolled transaction from the resale price to non-related parties for goods purchased. The resale price method is usually used in the situation where the reseller performs only simple processing or resale of goods.

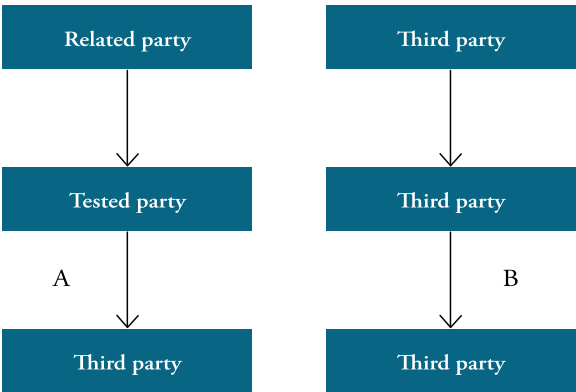
The formula is as follows:

$$\begin{aligned} \text{Arm’s Length Purchased Price} &= \text{Resale price to non-related parties} \\ &\times (1 - \text{Gross margin of comparable uncontrolled transaction}) \end{aligned}$$

Similar to the CUP, the resale price method can be applied on an internal or external basis. Each is illustrated below:



Similar products, limited value added by tested party distributor: compare gross margin on X with gross margin on Y



Similar products, limited value added by tested party distributor: compare gross margin on A with gross margin on B

The potential problems with the application of the resale price method using external data are the availability and reliability of data in respect of the gross margins being achieved by third parties in comparable circumstances as well as the different accounting policies that may be adopted by companies in accounting for expense items as either a cost of goods sold or as an operating expense, which can distort the results considerably.

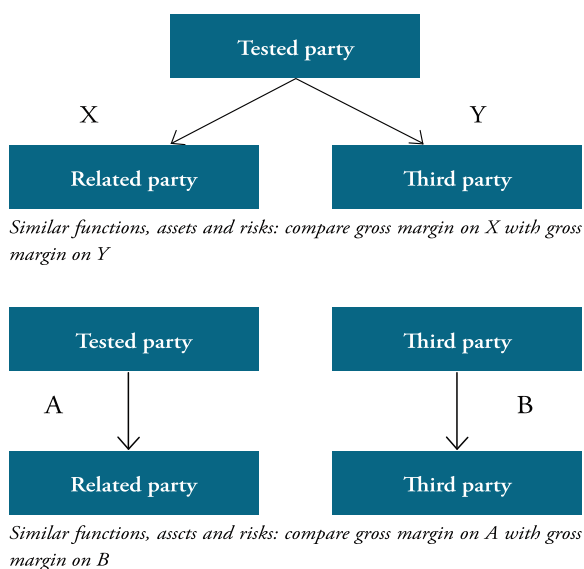
Cost Plus Method

Under the cost plus method, the arm's length price reflects the full cost of the underlying goods or services plus a gross profit mark-up. The cost plus method is usually applied to the related party transactions of manufacturing (particularly on a toll or contract basis) as well as the provision of services.

The formula is as follows:

$$\text{Arm's Length Price} = \text{Reasonable cost} \\ \times (1 + \text{cost plus margin of comparable uncontrolled transaction})$$

The application of the cost plus method is illustrated in the diagrams below. As with the other methods, it can be applied internally or externally.



Transactional Net Margin Method

The TNMM refers to the use of net profit margins from comparable uncontrolled transactions in setting or testing the net operating margin from a related party

transaction. The TNMM is usually applied to the related party transactions of sales, transfer and usage of tangible goods, provision of labor services, and transfer of intangible assets.

The types of profit level indicators that are typically referred to are:

- Return on equity
- Return on sales
- Mark-up on total costs
- Return on assets/capital employed
- Berry ratio (gross margin/operating expenses)

The selection of an appropriate profit ratio will be based on the primary driver of the profitability of the entity. For a manufacturer, return on assets may be more relevant, while for a distributor, the return on sales may be more logical.

In practice the TNMM is very widely used by both taxpayers and tax authorities. It overcomes the need for exact product comparability, avoids the concern regarding availability of gross margin data and cost classifications and, from a tax authority perspective, is the indicator that directly determines the amount of tax to be paid.

Profit Split Method

The profit split method refers to the methodology where the total profit on a transaction is allocated to each associated enterprise according to their respective contributions. The profit split method is usually applied in cases where the related party transaction is highly integrated and difficult to evaluate the operating result separately. There are two kinds of profit split method: (1) general profit split method; and (2) residual profit split method.

The general (or “contribution”) profit split method splits profit among associated enterprises according to the functions performed, risks borne and assets held, particularly intangible assets, which are contributed by each entity.

The residual profit split method requires the identification of the routine profit for an entity as a first step. Any remaining profit is then split based on each party’s contribution to the earning of the non-routine profit e.g. ownership of intangibles.

The application of the profit split method requires a careful analysis of the functions performed, risks borne and assets used by each associated enterprise as well as the allocation of cost, expense, earnings, and capital between associated enterprises involved in the transaction

Other Methods

If the methods stipulated above cannot be applied separately, combined methods or other methods consistent with the arm’s length principle may be used. However,

in the context of China, with a developing transfer pricing regime, it is difficult to envisage how unfamiliar methods may be interpreted by the tax authorities. It is recommended that they are at least supported by a more recognized method to the extent possible.

Link with Responsibility Center Profile

The table below provides, as an example only, a link between the business model, responsibility center profile and choice of transfer pricing methodology. Although each case is different it may serve as a useful reference point in methodology selection.

Functions	Model	Responsibility center	Price setting/profit checking method
Procurement	Sourcing	Cost center	Cost plus/TNMM
	Procurement agent	Revenue center	TNMM
	Full risk procurement	Profit center	TNMM/profit split
	Toll	Cost center	Cost plus/TNMM
Manufacturing	Contract	Cost center	Cost plus/TNMM
	Full risk	Profit center	TNMM/profit split
	Agent	Revenue center	TNMM
Sales	Limited risk	Revenue center	Resale price/TNMM
	Full risk	Profit center	TNMM/profit split

Economic Analysis

Once the methodology has been selected, the economic analysis, or application of that methodology, must be undertaken.

The application of the cost plus, resale price and TNMM on an external basis involves the use of commercial databases such as those created by Bureau van Dijk (for practical purposes, it should be noted that the license fees to access such databases mean that it is generally not feasible to perform this part of the analysis inhouse). Tax authorities generally also have access to such databases and may also develop their own based on tax return and other non-public data.

In China, Article 20 of Guo Shui Fa (1998) No. 59 required tax authorities to establish a transfer pricing database that should contain income tax return data, market prices of main commodities, trade and industrial profitability ratios, borrowing and lending interest rates as well as structural and managerial information of multinational enterprises. The ruling stipulates that the database should be

shared within the tax administration system and should not be available to the public.

Such data is referred to as “secret comparables” and, when used to adjust a taxpayer’s profitability, is widely considered to be unreasonable as the taxpayer does not have sufficient information to defend themselves.

There have been some mixed signals from the SAT on whether such “secret comparables” will be used significantly in China. In a welcome move, the agency issued Guo Shui Han (2005) No. 239 recommending that taxpayers conduct their own comparability studies using the financial databases published by Bureau van Dijk. In practice, it is likely that a search of the Bureau van Dijk databases carried out in accordance with OECD best practice and fully and accurately documented will strongly discourage the use of secret comparables by the investigating tax bureau. However, in the China Transfer Pricing Regulations the possibility of the tax authorities using such data is again mentioned, so in this case it is uncertain how this will be applied in practice.

Capital Intensity Adjustments

This refers to the practice of adjusting the profitability of the comparable companies to equate them to the same proportionate level of receivables, payables and inventory as the tested party. Such adjustments are widely used by tax authorities and taxpayers around the world, particularly in the US context.

However, in July 2005 the SAT released Guo Shui Han (2005) No. 745 stating that local tax authorities should not use capital intensity adjustments in carrying out comparability studies, unless there is strong support for doing so. It is likely that the SAT has taken this position due to the prevalence of state-owned Chinese companies that may be used as comparables, with abnormally high levels of working capital (especially inventory holdings), with the result that capital intensity adjustments could result in benchmarking results with unacceptably low profit ranges, or even losses.

Box 4: Transfer Pricing Controversy Management

The premise of the transfer pricing process is that by designing and implementing a system that supports your business model (Boxes 1 and 2), and documenting such system in a comprehensive and timely manner (Box 3) the risk of issues in Box 4 is greatly mitigated.

There are always potential conflicts that can arise between tax authorities and taxpayers, leading to some common questions:

- Can the losses of an entity be explained by reference to its function, asset and risk profile? If the entity is classed as a contract manufacturer, is it earning consistent routine profitability?
- Did the group company really provide any intra-group services to the recipient company, and if so, did the services benefit the recipient group company, and if so, is the charge commensurate with the benefit received such that a third party would have been willing to pay the charge?
- Since the brand name was built up by the local group company, why should it pay a royalty to the so-called legal owner of the brand?

Chapter titled [Transfer Pricing Audits and Enforcement](#) further discusses the transfer pricing audit environment in China and how to best manage this process if and when it arises.

Transfer Pricing in China

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