The Arm’s length principle
Application in Norwegian and international tax law - an introduction
Agenda

The Arm’s length principle (ALP)
- What is the ALP and why do we need it
- Short historical background
- The OECD TP Guidelines
  - Delineation/Risk allocation
  - Transfer pricing methods
- Legal base for application in Norway
  - Binding advance rulings

Practical examples
- Loan pricing
- Pricing of intangibles
  - Residual models based on TNMM

Background for state aid discussion
The need of TP rules for taxation purposes

Example transaction

Ireland
12,5 %

Norway
22 %

Sale of goods
Price 100 or 150

X ltd.

X AS

Taxable income X AS

Price 100  150
Sales income  200  200
Cost of goods  100  150
Taxable income  100  50

✓ TP rules - Arm’s length principle
Purpose of transfer pricing rules

**Country/OECD perspective**
- Avoid economic double taxation
- Distortion of trade
- Fair competition
- Protect tax base

**Company perspective**
- Avoid economic double taxation
- Distortion of trade
- Unfair competition
- Legal tax planning - optimize taxes through pricing:
  - Income to low tax countries
  - Costs to high tax countries
### History of the Arm’s length principle in 2 minutes

<table>
<thead>
<tr>
<th>Event</th>
<th>Product</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1979</strong>: OECD report</td>
<td></td>
</tr>
<tr>
<td><strong>1995</strong>: TP Guidelines</td>
<td></td>
</tr>
<tr>
<td><strong>2010</strong>: TP Guidelines</td>
<td></td>
</tr>
<tr>
<td><strong>2015</strong>: BEPS project:</td>
<td></td>
</tr>
<tr>
<td><strong>2017</strong>: TP Guidelines - “substance over form”</td>
<td></td>
</tr>
<tr>
<td><strong>2018</strong>: profit split revision</td>
<td></td>
</tr>
<tr>
<td><strong>2018</strong>: Financial transactions</td>
<td>Draft issued for commentary</td>
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<tr>
<td></td>
<td>Not finalized</td>
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</table>
The Arms length Principle – OECD model convention art. 9

**Arm’s length principle (ALP)**

**ARM’S LENGTH PRICE**

- ‘Arms length price ’ means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

**Essence of the ALP/OECD TPG**

- Compares the internal transaction(s) with comparable uncontrolled transaction(s)
- Under comparable circumstances
- Makes adjustment for relevant differences
- Analysis results in an **interval** of arm’s length prices or margins
- If price is outside interval – tax adm. may adjust price accordingly
The July 2017 OECD Transfer Pricing Guidelines - at a glance

<table>
<thead>
<tr>
<th>Content</th>
<th>9 Step Procedure</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Chapter 1 Arm’s length Principle</td>
<td>✓ Step 1 Years to be covered</td>
</tr>
<tr>
<td>✓ Chapter 2 Transfer Pricing Methods</td>
<td>✓ Step 2 Broad based analysis of taxpayers circumstances (market, regulations, etc)</td>
</tr>
<tr>
<td>✓ Chapter 3 Comparability Analysis</td>
<td>✓ Step 3 Understanding the controlled transactions (FAR analysis, delineation)</td>
</tr>
<tr>
<td>✓ Chapter 4 Administrative approaches</td>
<td>✓ Step 4 Review of internal comparables</td>
</tr>
<tr>
<td>✓ Chapter 5 Documentation</td>
<td>✓ Step 5 Review of external comparables</td>
</tr>
<tr>
<td>✓ Chapter 6 Intangibles</td>
<td>✓ Step 6 Choice of TP method and PLI</td>
</tr>
<tr>
<td>✓ Chapter 7 Intra Group Services</td>
<td>✓ Step 7 Identification of comparables</td>
</tr>
<tr>
<td>✓ Chapter 8 Cost Contribution Arrangements</td>
<td>✓ Step 8 Adjustments (if any)</td>
</tr>
<tr>
<td>✓ Chapter 9 Business restructurings</td>
<td>✓ Step 9 Establishing arm’s length interval</td>
</tr>
<tr>
<td>✓ Annexes</td>
<td></td>
</tr>
</tbody>
</table>
OECD TPG - the 5 comparability factors and the concept of delineation

5 Comparability factors  TPG 1.36

- Contractual Terms of the transaction
- Functions, assets and risks including how these relate to the wider generation of value by the MNE
- Characteristics of property or services
- The economic circumstances of
  - the parties
  - and of the market
- Business strategies pursued by the parties

Delineation - “substance over form”

- OECD TPG article 1.45: “If the characteristics of the transaction that are economically relevant are inconsistent with the written contract between the associated enterprises, the actual transaction should generally be delineated for purposes of the transfer pricing analysis in accordance with the characteristics of the transaction reflected in the conduct of the parties.”
OECD TPG – Risk allocation

5 step procedure

1. Identify relevant risks
2. Contractual allocation of risk
3. Which party is able to control the risk
   - Functionally (outsourcing possible)
   - Financially
4. Analyse 2 and 3
5. Allocation of risk based on control
   - To one party
   - Both - concept of «most control»

OECD TPG 1.98 - “substance over form”

« 1.98 If it is established (…) that the associated enterprise assuming the risk (…) does not exercise control over the risk or does not have the financial capacity to assume the risk, then the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk. »
OECD TPG – The 5 (6) TP-methods

**Traditional Transactional methods**

- **Comparable Uncontrolled Price Method (CUP)** – compares the price
  - Typical use:
    - Commodities
    - Financial transactions
- **Resale Minus**: compares the resale margin
  - Typical use:
    - Trading activities/marketing operations
- **Cost Plus**: compares the cost markup
  - Typical use:
    - Services, Semi finished goods

**Transactional profit methods**

- **Transactional Net Margin Method (TNMM)**
  - net profit relative to an appropriate base (e.g. costs, sales, assets)
  - Not one but several methods
  - Similar to the resale or cost plus
- **Profit Split**:
  - HTVI or highly integrated operations
  - Budgeted or actual profits
  - Allocation key should be
    - Consistent with FAR analysis
    - Reflect value creation
    - Be objective and verifiable
- **“Other methods” - especially valuation**
  - Discounted cash flow methods
  - Multiples
Use of the ALP – choice of method – lack of comparables

<table>
<thead>
<tr>
<th>Choice of method</th>
<th>Lack of comparables - Solutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ «Most appropriate method»</td>
<td>✓ TNMM benchmarking on company level</td>
</tr>
<tr>
<td>✓ Preference for CUP if available</td>
<td>✓ Non transactional third party data</td>
</tr>
<tr>
<td>✓ TNMM and cost plus – one sided</td>
<td>✓ Practical main rule</td>
</tr>
<tr>
<td>methods for «the less complex» party</td>
<td>✓ Accepted by 2017 TPG, cf. Article 3.37</td>
</tr>
<tr>
<td>✓ Profit split – only if</td>
<td>✓ Sacrifices a lot of comparability</td>
</tr>
<tr>
<td>✓ «highly integrated business» or</td>
<td>✓ Functional profile</td>
</tr>
<tr>
<td>✓ «unique contributions» from both</td>
<td>✓ Risk profile</td>
</tr>
<tr>
<td></td>
<td>✓ Profit split</td>
</tr>
<tr>
<td></td>
<td>✓ Requirements for use of method:</td>
</tr>
<tr>
<td></td>
<td>✓ Unique/valuable contributions</td>
</tr>
<tr>
<td></td>
<td>✓ Integrated businesses</td>
</tr>
<tr>
<td></td>
<td>✓ Allocation keys</td>
</tr>
</tbody>
</table>
Practical TP - Use of commercial databases/IT tools

S&P Global Ratings

BUREAU VAN DIJK

Moody’s

orbis

Bloomberg
Norwegian legal base – Arm’s length principle

General Tax Act section 13-1

✓ 3 Cumulative requirements for application:
  ✓ Reduction of income
  ✓ Related parties
  ✓ Causal requirement

✓ If requirements are met:
  ✓ Tax adm. may increase income
  ✓ Discretionary assessment
  ✓ Still has to fulfill ALP

Legal status of the OECD TPG

✓ 13-1 (3) «Shall be taken into consideration»
✓ More than «soft law»
✓ Use of different versions of TPG
  ✓ New versions applied «at once»
  ✓ Issues related to retroactive use of new versions of TPG for older years, cf.
  Constitution § 97

OECD TP Guidelines - the most important source for interpretation of ALP
Norwegian TP audits – no possibility for «special advance deals»

- No Binding Rulings available for pricing purposes
  - Exception for gas pricing
  - Guiding (non binding) is possible
- APAs according to tax treaties
  - Possible
  - Bi-lateral
  - Thorough audit process
- Ordinary tax audit
  - Thorough, risk based process
  - NTA TP section ca 75 employees
- General principle of equal treatment
The importance of Transfer Pricing - Norway

<table>
<thead>
<tr>
<th>2017 (NOK billions)</th>
<th>Total</th>
<th>40 largest</th>
<th>40 largest %</th>
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<tbody>
<tr>
<td>Total internal transactions</td>
<td>2 685</td>
<td>1020</td>
<td>38 %</td>
</tr>
<tr>
<td>Foreign transactions</td>
<td>1 357</td>
<td>756</td>
<td>56 %</td>
</tr>
<tr>
<td>Norwegian transactions</td>
<td>1 328</td>
<td>264</td>
<td>20 %</td>
</tr>
</tbody>
</table>
Practical example – loan pricing

- Contract
- Credit rating
  - Synthetic Credit rating (Moody’s/S&P)
  - Effect group membership – notching up
- Maturity
  - Contract
  - Purpose of loan
  - Actual conduct (payments)
  - Treatment in annual accounts

Delineation of transaction

Comparability analysis – CUP method

**Reuters Corporate Bond Spread Tables**

<table>
<thead>
<tr>
<th>Rating</th>
<th>1yr</th>
<th>2yr</th>
<th>3yr</th>
<th>5yr</th>
<th>7yr</th>
<th>10yr</th>
<th>30yr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aaa/AAA</td>
<td>20</td>
<td>26</td>
<td>50</td>
<td>25</td>
<td>85</td>
<td>45</td>
<td>74</td>
</tr>
<tr>
<td>Aa1/AA+</td>
<td>25</td>
<td>31</td>
<td>55</td>
<td>30</td>
<td>90</td>
<td>50</td>
<td>70</td>
</tr>
<tr>
<td>Aa2/AA</td>
<td>30</td>
<td>36</td>
<td>61</td>
<td>36</td>
<td>95</td>
<td>55</td>
<td>84</td>
</tr>
<tr>
<td>Aa3/AA-</td>
<td>35</td>
<td>41</td>
<td>66</td>
<td>41</td>
<td>100</td>
<td>60</td>
<td>89</td>
</tr>
<tr>
<td>A1/A+</td>
<td>40</td>
<td>46</td>
<td>71</td>
<td>51</td>
<td>105</td>
<td>81</td>
<td>100</td>
</tr>
<tr>
<td>A2/A</td>
<td>60</td>
<td>60</td>
<td>76</td>
<td>61</td>
<td>110</td>
<td>91</td>
<td>124</td>
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<tr>
<td>A3/A-</td>
<td>85</td>
<td>93</td>
<td>98</td>
<td>71</td>
<td>115</td>
<td>100</td>
<td>120</td>
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<tr>
<td>Baa1/BBB+</td>
<td>112</td>
<td>115</td>
<td>122</td>
<td>120</td>
<td>179</td>
<td>152</td>
<td>177</td>
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<tr>
<td>Baa2/BBB</td>
<td>150</td>
<td>134</td>
<td>150</td>
<td>145</td>
<td>186</td>
<td>182</td>
<td>202</td>
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<tr>
<td>Baa3/BBB-</td>
<td>215</td>
<td>177</td>
<td>240</td>
<td>250</td>
<td>250</td>
<td>236</td>
<td>255</td>
</tr>
<tr>
<td>B1/B+</td>
<td>355</td>
<td>350</td>
<td>441</td>
<td>416</td>
<td>391</td>
<td>345</td>
<td>355</td>
</tr>
<tr>
<td>B2/B+</td>
<td>466</td>
<td>416</td>
<td>494</td>
<td>516</td>
<td>466</td>
<td>419</td>
<td>455</td>
</tr>
<tr>
<td>B3/B-</td>
<td>541</td>
<td>404</td>
<td>541</td>
<td>491</td>
<td>491</td>
<td>444</td>
<td>483</td>
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<tr>
<td>B1/B-</td>
<td>591</td>
<td>569</td>
<td>616</td>
<td>616</td>
<td>545</td>
<td>469</td>
<td>499</td>
</tr>
<tr>
<td>B2/B</td>
<td>616</td>
<td>666</td>
<td>716</td>
<td>716</td>
<td>616</td>
<td>597</td>
<td>513</td>
</tr>
<tr>
<td>Caa/CCC+</td>
<td>644</td>
<td>744</td>
<td>744</td>
<td>744</td>
<td>725</td>
<td>625</td>
<td>525</td>
</tr>
</tbody>
</table>

US Treasury Yield

<table>
<thead>
<tr>
<th>1 yr</th>
<th>2 yr</th>
<th>3 yr</th>
<th>5 yr</th>
<th>7 yr</th>
<th>10 yr</th>
<th>30 yr</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.26</td>
<td>0.48</td>
<td>0.74</td>
<td>1.41</td>
<td>2.05</td>
<td>2.65</td>
<td>3.77</td>
</tr>
</tbody>
</table>

Spread values represent basis points (bps) over a US Treasury security of the same maturity, or the closest matching maturity.

**Methodology:**

Reuters Pricing Service (RPS) has eight experienced evaluators responsible for pricing approximately 20,000 investment grade corporate bonds. Corporate bonds are segregated into four industry sectors: industrial, financial, transports, and utilities. RPS prices corporate bonds at a spread above an underlying treasury issue. The evaluators obtain the spreads from brokers and traders at various firms. A generic spread for each sector is created using input from street contacts and the evaluator’s expertise. A matrix is then developed based on sector, rating, and maturity.
Practical example – residual models (IP)

Residual model – illustration

Delineation issues

- What are the parties contributing in respect of functions, assets and risks?
- Is contract consistent with «conduct of the parties»?
- Is IPR owner able to control risk?
- Is there no IP in the other companies?
- Is choice of method in accordance with economic realities/FAR analysis?
Thank you for your attention!

Georg Smidt Børresen
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