The Norwegian
Tax Administration

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

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**

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Purpose of transfer pricing rules

Country/OECD perspective	Company perspective
✓Avoid economic double taxation	✓Avoid economic double taxation
✓Distortion of trade	✓Distortion of trade
✓Fair competition	✓Unfair competition
✓Protect tax base	✓Legal tax planning - optimize taxes through pricing:
	✓Income to low tax countries
	✓Costs to high tax countries

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History of the Arm's length principle in 2 minutes

Event

- ✓**1920-30**: Tax treaties introducing ALP
- ✓**1979** OECD report
- ✓**1995** TP Guidelines
- ✓**2010** TP Guidelines
- ✓**2015** BEPS project:
  - ✓**2017** TP Guidelines - "substance over form"
  - ✓**2018** profit split revision
  - ✓**2018** – Financial transactions
    - ✓Draft issued for commentary
    - ✓Not finalized

Product

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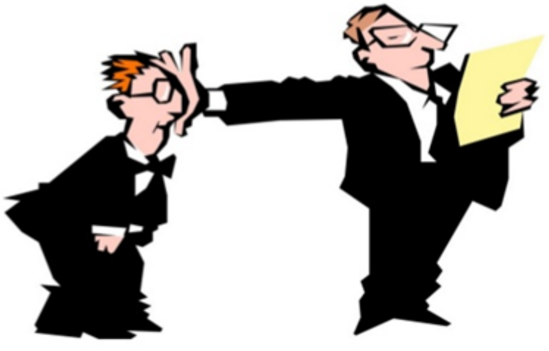
The Arms length Principle – OECD model convention art. 9

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 <u>other than associated enterprises</u>, <u>in uncontrolled conditions.</u>



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

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The July 2017 OECD Transfer Pricing Guidelines - at a glance

Content	9 Step Procedure
✓**Chapter 1** Arm's length Principle	✓ **Step 1** Years to be covered
✓**Chapter 2** Transfer Pricing Methods	✓ **Step 2** Broad based analysis of taxpayers circumstances (market, regulations, etc)
✓**Chapter 3** Comparability Analysis	✓ **Step 3** Understanding the controlled transactions (FAR analysis, delineation)
✓**Chapter 4** Adminstrative approaches	✓ **Step 4** Review of internal comparables
✓**Chapter 5** Documentation	✓ **Step 5** Review of external comparables
✓**Chapter 6** Intangibles	✓ **Step 6** Choice of TP method and PLI
✓**Chapter 7** Intra Group Services	✓ **Step 7** Identification of comparables
✓**Chapter 8** Cost Contribution Arrangements	✓ **Step 8** Adjustments (if any)
✓**Chapter 9** Business restructurings	✓ **Step 9** Establishing arm's length interval
✓Annexes	

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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

Risk allocation	OECD TPG 1.98 - "substance over form"
✓**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»	✓ « **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 activitites/marketing operations
- ✓**Cost Plus:** compares the cost mark up
- ✓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

Choice of method	Lack of comparables - Solutions

Choice of method

- ✓«Most appropriate method»
- ✓Preference for CUP if available
- ✓TNMM and cost plus – one sided methods for «the less complex» party
- ✓ Profit split – only if
  - ✓«highly integrated business» or
  - ✓ «unique contributions» from both

Lack of comparables - Solutions

- ✓ TNMM benchmarking on company level
- ✓ Non transactional third party data
  - ✓ Practical main rule
- ✓ Accepted by 2017 TPG, cf. Article 3.37
  - ✓ Sacrifices a lot of comparability
  - ✓ Functional profile
  - ✓ Risk profile
- ✓ Profit split
  - ✓ Requirements for use of method:
    - ✓ Unique/valuable contributions
    - ✓ Integrated businesses
  - ✓ Allocation keys

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Practical TP - Use of commercial databases/IT tools

S&P Global Ratings

THOMSON REUTERS

BUREAU VAN DIJK

MOODY'S

orbis

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Norwegian legal base – Arm's length principle

General Tax Act section 13-1	Legal status of the OECD TPG

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

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Norwegian TP audits – no possibility for «special advance deals»

Norwegian TP Audits	Special treatment for multinational Enterprises?

- ✓No Binding Rulings avilable 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 proces
  - ✓NTA TP section ca 75 employees
- ✓General principle of **equal treatment**

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The importance of Transfer Pricing - Norway

Total transactions reported to NTA by MNEs 2017 (Source: RF 1123)

2017 (NOK billions)	Total	40 largest	40 largest %
Total internal transactions	2 685	1020	38 %
Foreign transactions	1 357	756	56 %
Norwegian transactions	1 328	264	20 %

Practical example – loan pricing

Delineation of transaction

- ✓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 acounts

Comparability analysis – CUP method

REUTERS CORPORATE BOND SPREAD TABLES

Reuters Corporate Spreads for Industrials
September 2010 Average

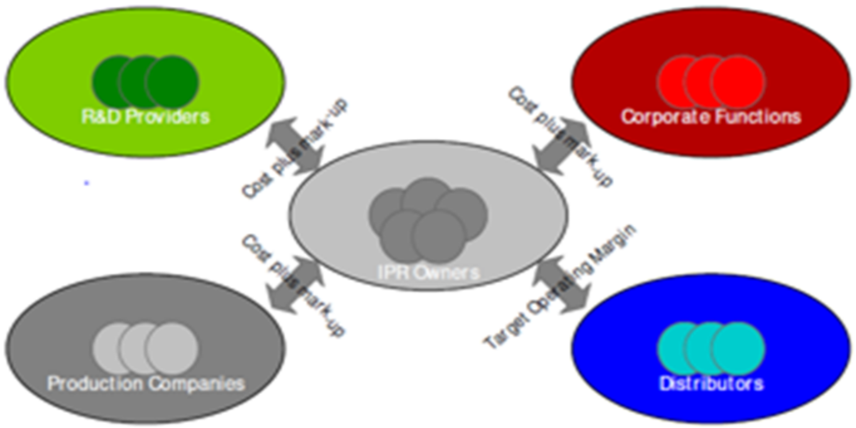
Rating	1 yr	2 yr	3 yr	5 yr	7 yr	10 yr	30 yr
Aaa/AAA	20	26	50	25	85	45	74
Aa1/AA+	25	31	55	30	90	50	79
Aa2/AA	30	36	61	36	95	55	84
Aa3/AA-	35	41	66	41	100	60	89
A1/A+	40	46	71	51	105	81	109
A2/A	60	60	76	61	110	91	124
A3/A-	95	93	98	71	115	109	129
Baa1/BBB+	113	115	125	130	179	152	177
Baa2/BBB	150	134	150	145	186	182	202
Baa3/BBB-	215	177	240	250	250	236	255
Ba1/BB+	366	350	441	416	391	345	358
Ba2/BB	466	416	494	516	466	419	455
Ba3/BB-	541	494	541	541	491	444	483
B1/B+	591	569	616	616	545	469	499
B2/B	616	666	716	716	616	597	513
B3/B-	644	744	744	741	725	625	525
Caa/CCC+	741	791	794	841	850	775	750
US Treasury Yield	0.26	0.48	0.74	1.41	2.05	2.65	3.77

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?

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Thank you for your attention!

Georg Smidt Børresen
Assistant director general
NTA, Section Transfer Pricing
Georgsmidt.borresen@skatteetaten.no