Decoding Transfer Pricing with GT UAE

Transfer Pricing Methods

October 2024

Transfer Pricing ("TP") methods are used to establish whether Controlled Transactions* are conducted at arm's length and provide clear guidelines for determining the appropriate pricing.

There are five internationally accepted TP methods detailed in the January 2022 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Transfer Pricing Guidelines") and incorporated under Article 34(3) of the Federal Decree-Law No. 47 of 2022 on Taxation of Corporations and Businesses ("Corporate Tax Law") as outlined below.

Transfer Pricing Method		
Traditional	**Transactional**	**Others**
Comparable Uncontrolled Price Method	Transactional Net Margin Method	Other Method
Resale Price Method	Profit Split Method	
Cost-plus Method		

Apart from that, Article 34(4) of the Corporate Tax Law also allows the use of other methods to calculate the Arm's Length Price when the five recognized Transfer Pricing methods cannot be reasonably or reliably applied, provided they meet the Arm's Length Principle. Where an alternative Transfer Pricing method has been used, adequate supporting documentation explaining the reasons for selecting the method should be provided. For example, in unique transactions like a real estate development lease from a related party, a Discounted Cash Flow ("DCF") method might be used. However, thorough documentation is required to justify the choice and ensure transparency.

** A "Controlled Transaction" is a transaction or arrangement between Related Parties or Connected Persons per the TP Guide.*

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In cases where the application of one of the Transfer Pricing methods proves inconclusive, a combination of methods may be the most accurate approach. Where a combination of methods is used to test the Arm's Length Principle, the primary aim should be to reach a conclusion that takes account of the facts, circumstances and available evidence of the case per the Transfer Pricing Guide, issued by the Federal Tax authority, October 2023 ("TP Guide").

As per the TP Guide, there is no absolute hierarchy in relation to applying traditional transaction methods. However, traditional transaction methods are regarded as the most direct way of establishing whether transactions and arrangement between Related Parties and Connected Persons are in accordance with the arm's length standard.

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Comparable Uncontrolled Price Method

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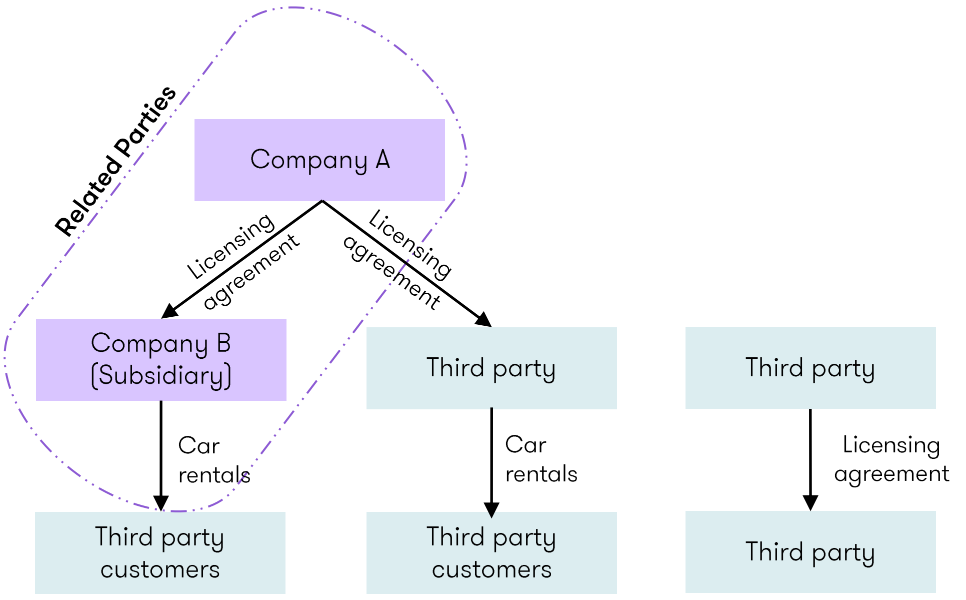
The Comparable Uncontrolled Price ("CUP") method is a TP method that compares the price for property or services transferred in a Controlled Transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. Similar pricing would indicate that the transaction has taken place at arm's length. However, any material differences would require sufficient comparability adjustments to ensure alignment with the uncontrolled transaction. There are two ways to apply the CUP method: internal CUP and external CUP.

Example 1:



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Comparable Uncontrolled Price Method

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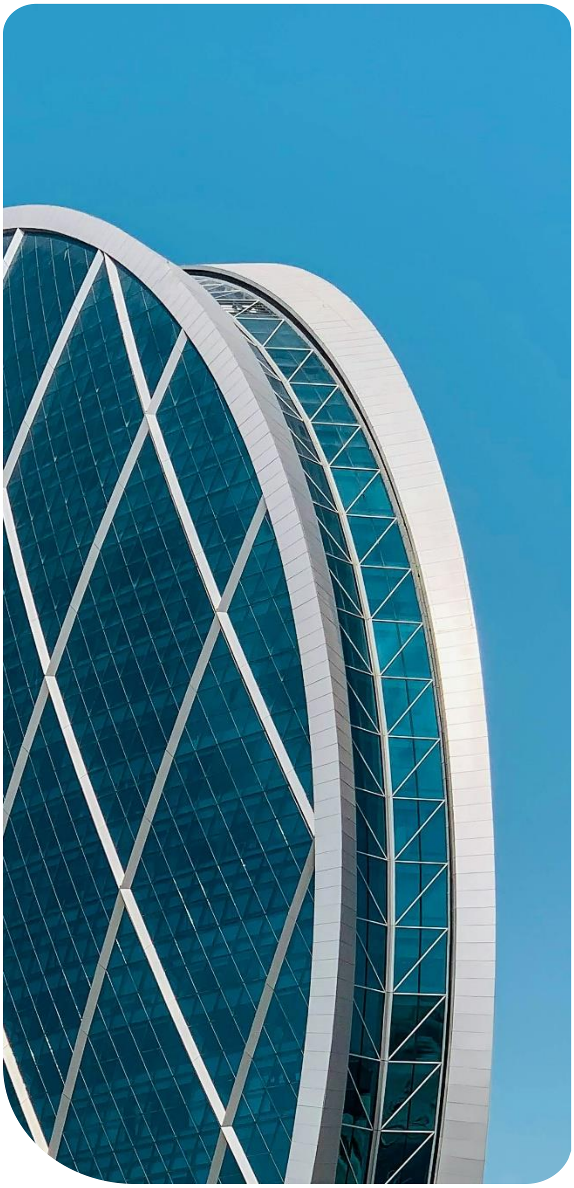
- A car rental company, Company A, has a subsidiary named Company B in a different jurisdiction. Company B uses the brand name and logo under a licensing agreement with Company A for the car rental business locally. Company A would like to determine how to price the use of its brand name and logo by Company B.
- Company A found an example of a licensing agreement it has made with an independent third party to use their branding, which is comparable. In this case, Company A uses the same price it charges the independent third party to its subsidiary Company B for the use of the brand and logo.
- However, in case the licensing agreement between Company A and the independent third party is not comparable, Company A may use an independent external database to find the external comparable licensing agreements to determine the price.



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Resale Price Method

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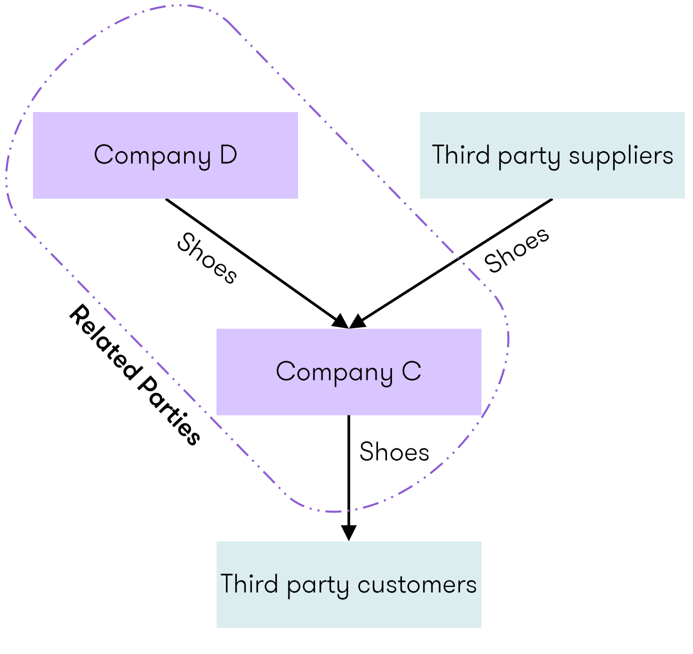
The Resale Price Method ("RPM") is based on the price at which a product, that has been purchased from a related party, is resold to an independent party. The resale price would be reduced by the gross "Resale Price Margin", as well as any other costs associated with the transaction, to provide an Arm's Length Price.

The "Resale Price Margin" represents the amount out of which a reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), to make an appropriate profit.

Typically, the RPM is applied to a reseller in a Controlled Transaction to compare their margins with those from a comparable uncontrolled transaction, particularly when the reseller adds minimal value to the property.

Example 2:



- Company C distributes running shoes buying shoes from a related company, Company D in a different country.
- It also purchases similar shoes from another, unrelated supplier.
- Assuming that the terms and conditions of the related and unrelated party transactions are comparable, the RPM can be applied to ensure that Company D charges its related party, Company C, a price comparable to the price charged by the unrelated third-party supplier.

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Cost-plus Method

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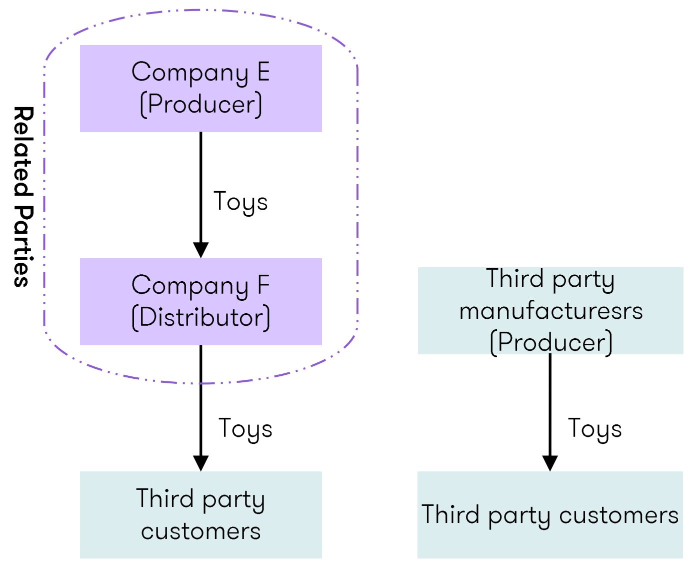
The Cost-plus Method ("CPM") considers the direct and indirect costs incurred by a supplier in supplying goods or services in a Controlled Transaction and applies an appropriate mark-up to these costs based on the functions performed by the supplier and the profit that would have been earned from an arm's length transaction depending on market conditions.

The CPM is most useful where semi-finished goods are sold between Related Parties or Connected Persons, where Related Parties or Connected Persons have concluded joint facility agreements or long-term buy-and-supply arrangements, as well as where the Controlled Transaction is the provision of services.

Example 3:



- Company E produces toys under contract for its parent company called Company F. Company F then sells the goods to the third-party customers. Company E would like to determine the appropriate markup (gross cost plus) for the toys it sells to Company F.
- In the same market, comparable independent manufacturers produce similar toys. As such, Company E may apply those comparable companies' gross cost plus to the transactions with related Company F.
- A Related Party using the CPM should ensure consistent accounting practices in both Controlled and Comparable Uncontrolled Transactions. If inconsistencies exist and adjustments can't be reliably made, an internal CUP may be used if Company E has a comparable third-party contract.

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Transactional Net Margin Method

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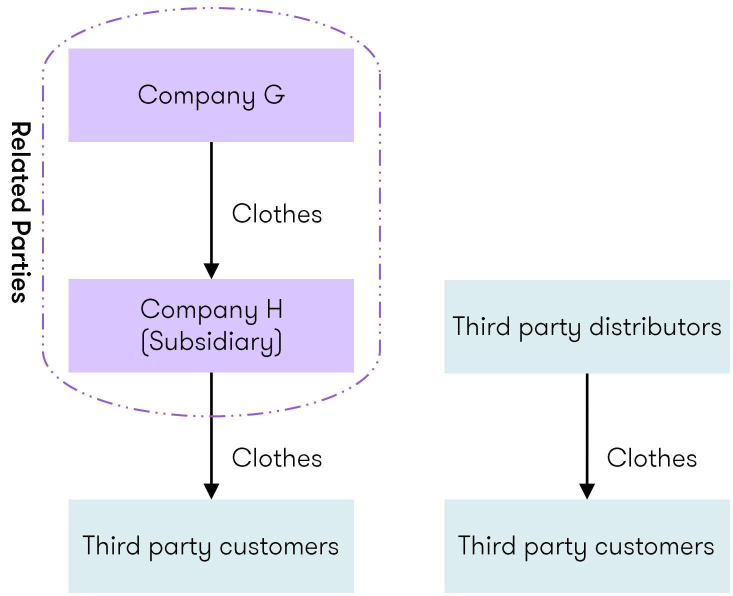
The Transactional Net Margin Method ("TNMM") examines the net profit earned from a Controlled Transaction relative to an appropriate base, such as the costs, sales or assets.

The net profit margin earned in the Controlled Transaction should be established by reference to the net profit margin earned in internal or external Comparable Uncontrolled Transactions depending on the circumstances. TNMM would be suitable for transactions involving routine functions and relatively low-risk activities.

Example 4:



- Company G is a clothing company with global reach establishes a subsidiary Company H as a distributor in a different jurisdiction. Company G supplies clothes, sets business strategies, finances the global operations, and owns the intellectual property (trademarks, designs, and operational know-how) for its global affiliates including Company H. Company G would like to determine how much profit Company H should earn for its distribution operations.
- Company G identifies similar third-party distributors in the jurisdiction that Company H operates in, using an independent external database, calculates their pre-tax profit margins, and establishes a typical profit margin range. Prices are set to allow Company H to earn a pre-tax profit that falls within that typical margin range.

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Profit Split Method

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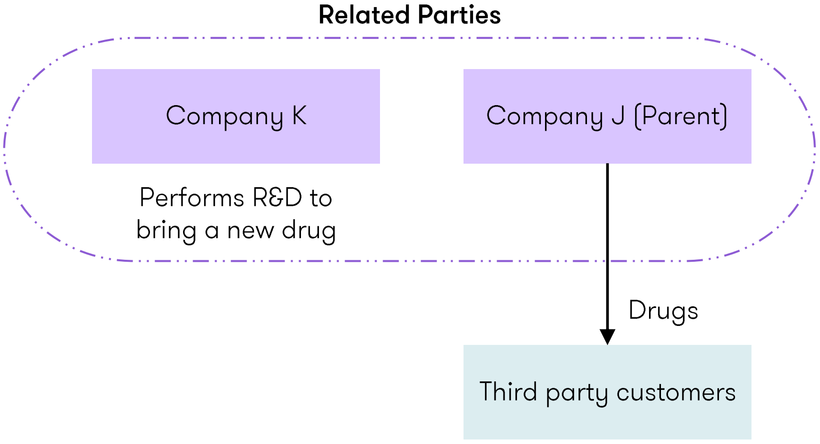
The Profit Split Method ("PSM") seeks to determine the division of profits that independent parties would have expected to realise from engaging in comparable transactions. This method first identifies the combined profits of the Related Parties or Connected Persons from a Controlled Transaction(s) and splits those profits on an economically valid basis.

The PSM is most applicable when Related Parties have highly integrated operations, make unique and valuable contributions, or share significant economic risks, making one-sided methods inappropriate.

Example 5:



- Company J is a pharmaceutical company who manufactures drugs with an affiliate Company K performs research and development ("R&D") to bring a new drug to market.
- Company K bears the costs and risks of launching the new drug. The two Related Parties would like to determine the right profit split and decide that they'll use the contribution PSM to divide profits from sales of the new drug.
- The two parties have invested a total of $500 million in bringing the medication to market. Company K invested $375 million—or 75% of the total investment. Therefore, 75% of the profits will go to Company K, with the remaining 25% going to Company J in the hypothetical situation.

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Next Steps

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- Evaluate the available TP methods to determine which one best applies to the specific transaction and meets the arm's length standard in a TP policy.
- Implement the selected TP method on the relevant transactions and ensure that the prices charged are aligned with the arm's length principle.
- Maintain detailed TP documentation justifying the selection of the method, ensuring it is compliant with regulatory requirements.
- Assess the consistency of the selected TP method across all the transactions with the Related Parties and Connected Persons on a regular basis.
- Regularly assess the TP method's applicability and make adjustments as needed to stay compliant with evolving business and regulatory environments.

Stay tuned for our next publication on Benchmarking flow chart (key factors of functional analysis, economic analysis).

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Contact our Transfer Pricing team

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For more details regarding this topic or other Tax issues, reach out to our team of experts on the latest Tax developments within the UAE and the Middle East region.

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