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PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES 2021

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Practical Manual on Transfer Pricing

for Developing Countries 2021

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Foreword to the Third Edition (2021)

PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES

This third edition of the United Nations Practical Manual on Transfer Pricing for Developing Countries (the Manual) is intended to draw upon the experience of the first edition (2013) and the second edition (2017) including feedback on the latter version, but it is also intended to reflect developments in the area of transfer pricing analysis and administration since that time.

During the 15th session of the UN Committee of Experts on International Cooperation in Tax Matters ("the Committee") in 2017 a new Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing ("the Subcommittee") was formed, to be Co-Coordinated by Ms. Ingela Willfors and Mr. Stig Sollund, with the following mandate:

The Subcommittee is mandated to review and update the United Nations Practical Manual on Transfer Pricing for Developing Countries, based on the following principles:

- *That it reflects the operation of Article 9 of the United Nations Model Convention, and the Arm's Length Principle embodied in it, and is consistent with relevant Commentaries of the United Nations Model;*
- *That it reflects the realities for, and the needs of, developing countries, at their relevant stages of capacity development;*
- *That special attention should be paid to the experience of developing countries, and the issues and options of most practical relevance to them; and*
- *That it draws upon the work being done in other forums.*

The Subcommittee shall give due consideration to the outcome of the OECD/G20 Action Plan on Base Erosion and Profit Shifting as concerns transfer pricing. The Manual shall reflect the special situation of least developed economies.

The Subcommittee shall report on its progress at the sessions of the Committee and provide its final updated draft Manual for discussion and adoption no later than the 22nd Session in 2021 and preferably in 2020.

An important purpose of this Manual is to contribute to a common understanding of how the arm's length principle is to be applied in order to avoid double taxation and prevent or resolve transfer pricing disputes, as highlighted in paragraph 4 of the Commentary on Article 9 of the UN Model Convention.

As proposed by the Subcommittee at the 17th Session and approved by the Committee, this third edition of the Manual makes improvements in usability and practical relevance, updates and improves the existing text, including on Country Practices (Part D) and has new content, in particular, on financial transactions, profit splits, centralized procurement functions and comparability issues. Improved capacity development based on the Manual has encouraged and contextualized developing country feedback, helped identify these priority areas for improvement and contributed to better targeting the messages in the Manual and examples used.

The Forewords to the first two editions of this Manual, which are retained in the following pages, remain relevant as to their substance. In particular, the Foreword to the First Edition recognizes that:

> "While consensus has been sought as far as possible, it was considered most in accord with a practical manual to include some elements where consensus could not be reached, and it follows that specific views expressed in this Manual should not be ascribed to any particular persons involved in its drafting. [Part D] is different from other chapters in its conception, however. It represents an outline of particular country administrative practices as described in some detail by representatives from those countries, and it was not considered feasible or appropriate to seek a consensus on how such country practices were described. [Part D] should be read with that difference in mind."

If anything, the share of intra group trade in global trade is probably higher than estimated in the first editions of the Manual, making the issues dealt with more important than ever.

As with the Subcommittees involved in drafting the earlier editions of this Manual, the current Subcommittee is comprised of Members from tax administrations and policy-makers with wide and varied experience in dealing with transfer pricing, as well as from academia, international organizations and the private sector, including from multinational enterprises and advisers. The Subcommittee met productively on many occasions: New York (February 2018 and May 2018); Quito (October 2018); Vienna University of Economics and Business (February 2019 and February 2020); IBFD, Amsterdam (July 2019); and Nairobi (December 2019). Short meetings were also held in the side-lines of some Committee sessions. The generosity of country and institutional hosts of Subcommittee meetings is warmly acknowledged, as is the valued support of the European Commission for some of these meetings and of the Norwegian Government in this and other Committee projects.

The members of the Subcommittee and their countries (in the case of government officials) or current affiliations (in other cases) bearing in mind that membership is assumed on a personal capacity, contributing to this updated version of the Manual at various times were,: Ingela Willfors (Sweden — Co-Coordinator); Stig Sollund (Norway — Co-Coordinator); Joseph Andrus (independent consultant); Rajat Bansal (India); Melinda Brown (OECD); Hafiz Choudhury (The M Group Inc., USA); Mathew Gbonjubola (Nigeria); Stefan Greil (Germany); Andrew Hickman (independent consultant); Mitsuhiro Honda (University of Tsukuba, Japan); Michael Kobetsky (Australian National University and Melbourne University, Australia); Michael McDonald (EY, USA); Toshio Miyatake (Adachi, Henderson, Miyatake and Fujita, Japan); George Obell (Kenya); Emily Muyaa (IBFD); T.P. Ostwal (T.P. Ostwal & Associates LLP, India); Raffaele Petruzzi (WU Transfer Pricing Center, Vienna University of Economics and Business, Austria); Christoph Schelling (Switzerland); Jolanda Schenk (Shell, Netherlands); Carlos Perez-Gomez Serrano (Royalty Range, Mexico); Caroline Silberztein (Baker & McKenzie, France); Monique van Herksen (Simmons & Simmons, Netherlands); José I. Troya González (Ecuador); Marcos Valadão (Getulio Vargas Foundation, Brasília, Brazil); Xiaoyue Wang (KPMG, China); Zhang Ying (China); and Sing Yuan Yong (Singapore). The assistance to the Subcommittee is also acknowledged of Marc Bochsler and Basil Peyer (both from Switzerland).

The additional special role of Subcommittee Member Mr. Hafiz Choudhury as a consultant is recognized with thanks. The assistance of the Secretariat, including especially Michael Lennard, Irving Ojeda Alvarez and Ilka Ritter, assisted by John Mutwiri Miriti, in this work is also gratefully acknowledged.

Note on paragraph numbering: To improve readability of this Third Edition of the Manual, a four-digit paragraph numbering system has been introduced. It is however, recognized that there is some transitional difference in numbering across chapters due to the amount of content under particular headings and sub-headings, which results in some very limited inconsistencies. The old numbers are however used when cross-referencing is made to the previous edition, usually in footnotes. A letter identification (e.g., "Part A") has been retained to identify parts of the Manual, but is no longer used in the paragraph numbering.

Foreword to the Second Edition (2017)

This second edition of the United Nations Practical Manual on Transfer Pricing for Developing Countries (the Manual) is intended to draw upon the experience of the first edition (2013) including feedback on that version, but it is also intended to reflect developments in the area of transfer pricing analysis and administration since that time.

At the Ninth Session of the United Nations Committee of Experts on International Cooperation in Tax Matters in October 2013, a Subcommittee was formed with the task, among others, of updating this Manual.

The mandate of the reconstituted *Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing* in relation to this Manual was as follows:

> *Update and enhancement of the United Nations Practical Manual on Transfer Pricing for Developing Countries*
>
> The Subcommittee as a Whole is mandated to update the United Nations Practical Manual on Transfer Pricing for Developing Countries, based on the following principles:
>
> - That it reflects the operation of Article 9 of the United Nations Model Convention, and the Arm's Length Principle embodied in it, and is consistent with relevant Commentaries of the UN Model;
> - That it reflects the realities for developing countries, at their relevant stages of capacity development;
> - That special attention should be paid to the experience of developing countries; and
> - That it draws upon the work being done in other forums.
>
> In carrying out its mandate, the Subcommittee shall in particular consider comments and proposals for amendments to the Manual and provide draft additional chapters on intra group services and management fees and intangibles, as well as a draft annex on available technical assistance and capacity-building resources such as may assist developing countries. The Subcommittee shall give due consideration to the outcome of the OECD/Group of Twenty (G20) Action Plan on Base Erosion and Profit Shifting as concerns transfer pricing and the Manual shall reflect the special situation of less developed economies.

> The Subcommittee shall report on its progress at the annual sessions of the Committee and provide its final updated draft Manual for discussion and adoption at the twelfth annual session of the Committee in 2016.

The Committee at its twelfth session recognized that the Subcommittee's mandate had been met and approved the proposed update to the Manual. The Manual is improved, and made more responsive to issues of current country concern and also more in tune with rapid developments in this area, including those relating to the OECD/G20 Action Plan on Base Erosion and Profit Shifting mentioned in the Subcommittee mandate. It was decided by the Subcommittee, and agreed by the Committee, that the Manual was not the best place for a draft annex on available technical assistance and capacity-building resources such as may assist developing countries, as mentioned in the mandate. This was considered better addressed by a webpage updated and managed by the UN Secretariat.

The changes in this edition of the Manual include:

- A revised format and a rearrangement of some parts of the Manual for clarity and ease of understanding, including a reorganization into four parts as follows:
  - Part A relates to transfer pricing in a global environment;
  - Part B contains guidance on design principles and policy considerations; this Part covers the substantive guidance on the arm's length principle, with Chapter B.1. providing an overview, while Chapters B.2. to B.7. provide detailed discussion on the key topics. Chapter B.8. then demonstrates how some countries have established a legal framework to apply these principles;
  - Part C addresses practical implementation of a transfer pricing regime in developing countries; and
  - Part D contains country practices, similarly to Chapter 10 of the previous edition of the Manual. A new statement of Mexican country practices is included and other statements are updated;
- A new chapter on intra group services;
- A new chapter on cost contribution arrangements;
- A new chapter on the treatment of intangibles;
- Significant updating of other chapters; and
- An index to make the contents more easily accessible.

The Foreword to the First Edition of this Manual, which is included below, remains relevant as to its substance. In particular, its recognition that:

> "While consensus has been sought as far as possible, it was considered most in accord with a practical manual to include some elements where consensus could not be reached, and it follows that specific views expressed in this Manual should not be ascribed to any particular persons involved in its drafting. [Part D][1] is different from other chapters in its conception, however. It represents an outline of particular country administrative practices as described in some detail by representatives from those countries, and it was not considered feasible or appropriate to seek a consensus on how such country practices were described. [Part D] should be read with that difference in mind."

As with the Subcommittee involved in drafting the first edition of this Manual, the current Subcommittee is comprised of Members from tax administrations with wide and varied experience in dealing with transfer pricing as well as Members from academia, international organizations and the private sector, including from multinational enterprises and advisers. The Subcommittee met successfully in New York (thrice), Santiago de Chile, Rome, and Bergamo, Italy, with the three last-mentioned meetings being made possible by the generosity of the host countries. The support of the European Commission's Directorate General for International Cooperation and Development (DEVCO) and especially its Budget Support and Public Finance Management Unit, was especially important in ensuring a successful meeting in Bergamo.

The members of the Subcommittee and their countries (in the case of government officials) or affiliations (in other cases) contributing to this updated version of the Manual at various times, were, although membership is assumed on a personal capacity: Stig Sollund (Norway—Coordinator); Joseph Andrus; Ganapati Bhat (India); Melinda Brown (OECD); Hafiz Choudhury (The M Group); Giammarco Cottani (Ludovici & Partners, Italy); Johan de la Rey (South Africa); Nishana Gosai (Baker & McKenzie, South Africa); Noor Azian Abdul Hamid (Malaysia); Toshiyuki Kemmochi (Japan); Michael Kobetsky (Australian National University and Melbourne University, Australia); Michael McDonald (USA); Toshio Miyatake (Adachi, Henderson, Miyatake and Fujita, Japan); T.P. Ostwal (TP Ostwal & Associates, India); Christoph Schelling (Switzerland); Jolanda Schenk (Shell, Netherlands); Carlos Perez-Gomez Serrano (Mexico) Caroline Silberztein

[1] Changes in square brackets are made to reflect the new structure of the Manual.

(Baker & McKenzie, France); Monique van Herksen; Marcos Valadão (Brazil); Xiaoyue Wang (China) Ingela Willfors (Sweden) and Ying Zhang (China). The assistance to the Subcommittee is also acknowledged of Mr. Cao Houle (China) and Mr. Marc Bochsler and Mr. Basil Peyer (both from Switzerland).

The additional special role of Subcommittee Member Mr. Hafiz Choudhury as technical coordinator is recognized with thanks. The assistance of the Secretariat, including Michael Lennard in particular, as well as Ilka Ritter and Tatiana Falcão, in this work is also acknowledged. Additional editorial work was conducted by Judy Goss.

Foreword to the First Edition (2013)

The United Nations Practical Manual on Transfer Pricing for Developing Countries is a response to the need, often expressed by developing countries, for clearer guidance on the policy and administrative aspects of applying transfer pricing analysis to some of the transactions of multinational enterprises (MNEs) in particular. Such guidance should not only assist policymakers and administrators in dealing with complex transfer pricing issues, but should also assist taxpayers in their dealings with tax administrations.

The United Nations Model Double Taxation Convention between Developed and Developing Countries[2] considers (at Article 9—"Associated Enterprises") whether conditions in commercial and financial relations between related enterprises, such as two parts of a multinational group, "differ from those which would be made between independent enterprises". The same test is applied at Article 9 of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital.3 In this respect both Models, which between them are the basis for nearly all bilateral treaties for avoiding double taxation, endorse the "arm's length standard" (essentially an approximation of market-based pricing) for pricing of transactions within MNEs.

While it is for each country to choose its tax system, this Manual is addressed at countries seeking to apply the "arm's length standard" to transfer pricing issues. This is the approach which nearly every country seeking to address such issues has decided to take. Such an approach minimizes double taxation disputes with other countries, with their potential impact on how a country's investment "climate" is viewed, while combating potential profit-shifting between jurisdictions where an MNE operates.

In recognizing the practical reality of the widespread support for, and reliance on, the arm's length standard among both developing and developed countries, the drafters of the Manual have not found it necessary, or helpful, for it to take a position on wider debates about other possible standards. The Manual will, at most, help inform such debates at the practical level, and

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2 UN (2011). *Model Double Taxation Convention between Developed and Developing Countries.* New York: UN Publishing. Available from https://www.un.org/esa/ffd/wp-content/uploads/2014/09/UN_Model_2011_Update.pdf

3 OECD (2010). *Model Tax Convention on Income and Capital.* Paris: OECD Publishing. Available from https://www.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version_20745419

encourage developing country inputs into debates of great importance to all countries and taxpayers.

There is a risk, without an effective response to transfer pricing issues, that profits might appear to be earned in low- or no-tax jurisdictions (thereby serving to reduce tax rates on taxable profits/incomes and associated tax obligations), and losses might appear to be incurred in high-tax jurisdictions (thereby increasing allowable deductions for tax purposes). This may have the net effect of minimizing taxes and, in so doing, may impact on the legitimate tax revenues of countries where economic activity of the MNE takes place, and therefore the ability of such countries to finance development.

For the purposes of this Manual, the term "mis-pricing" is used to refer in a short form to pricing that is not in accordance with the arm's length standard. It is not intended to imply that a tax avoidance or evasion motive necessarily exists in a particular case. From the country development perspective, the impact of non-arm's length pricing does not depend on whether or not such an intention exists, though that may of course affect how countries respond to particular instances of such behaviour.

There are as yet no figures which clearly indicate the amount of revenue lost to transfer mis-pricing that might otherwise be directed to development. However, with intra-firm trade generally regarded as comprising more than 30 per cent of global trade, there is reason to believe that the figures are large. While more research still needs to be done on the size of the potential losses for developing countries, and the situation will no doubt vary greatly from country to country, there is clearly great scope for pricing decisions about intra group transactions that detrimentally impact domestic revenues for development.

Conversely, in this complex area, there is a risk that taxpayers, especially MNEs, will be faced with a multiplicity of approaches to applying the arm's length standard in practice that can lead to compliance burdens and the risk of unrelieved double taxation. This can be the case even where there is no issue of tax avoidance or evasion, because of the scope for differences of view about what the arm's length price would be in a particular case. Helping achieve common understandings on transfer pricing issues can also improve trust between taxpayers and tax authorities, both avoiding some differences between them and helping resolve others more quickly.

In offering practical guidance to policymakers and administrators on the application of the arm's length principle, the Manual does not seek to be prescriptive. In particular it recognizes that the needs of countries, along with their capabilities, will evolve over time. A "phased" or "life cycle" approach, with a transfer pricing capability strategy identifying short-, medium- and longer-term objectives and areas of focus will therefore often yield the best results. It follows that many developing countries may find the early history of transfer pricing in developed countries to be of special relevance, as well as the current practices in other, especially developing, countries.

By showing ways in which the "arm's length" approach to transfer pricing can operate effectively for developing countries, while giving a fair and predictable result to those investing in such countries, the Manual will also help explain why that approach has been found so broadly acceptable, including in both major Model Tax Conventions. It should therefore assist countries in important decisions on how to address transfer pricing issues, whatever approach they ultimately take. It will also play a part in signposting areas where more support and assistance may be needed for countries at the various stages of their transfer pricing "journeys".

An approach to risk management will need to inform transfer pricing strategies, recognizing the areas of greatest mis-pricing risk, and the benefits of tax administrations constructively engaging with taxpayers to help them to know and meet their responsibilities. Resource-effective ways of addressing those risks from the points of view of both government and taxpayers will be of particular importance for developing country tax administrations.

There are a number of other guiding principles that have informed this Manual and reflect the mandate of the Subcommittee involved in its drafting, including that:

- This is a practical Manual rather than a legislative model;
- The drafting should be as simple and clear as the subject matter permits;
- The Manual will be prepared initially in English, but with a recognition that this will not be the first language of most users. It should be translated at least into the other official United Nations languages;
- A key "value added" of the Manual is to be its practicality—addressing real issues for developing countries (and of course those dealing with the administrations of such countries) in a practical and problem-solving way. It therefore seeks to address the theory of transfer pricing, but in a way that reflects developing country realities in this area;
- The Manual, as a product of the United Nations Committee

of Experts on International Cooperation in Tax Matters, has a special role in reflecting the diversity of the United Nations Membership and placing transfer pricing in its developmental perspective. This recognizes both the importance to development of fair and effective tax systems, but also the fact that foreign investment, on appropriate terms, is seen as an important path to development by most countries;

- Helpful guidance in this complex area must, in particular, be geared to the inevitable limitations in some countries' administrations, and deficits in information and skills that many countries are affected by in this area. Issues, in particular, of building and retaining capability as well as the need for focus and efficiency in dealing with limited resources, bear strongly on the approach taken in the Manual;
- Practical examples relevant to developing countries have been especially relied upon, because the experiences of other developing countries in addressing the challenges of transfer pricing are an important way of finding effective solutions that work in their context, and of doing so in the most cost and time effective ways; and
- Consistency with the OECD Transfer Pricing Guidelines[4] has been sought, as provided for in the Subcommittee's mandate and in accordance with the widespread reliance on those Guidelines by developing as well as developed countries.

Just as building an effective and efficient transfer pricing capability is a journey, so too is the preparation of a Manual seeking to give guidance for that journey. This Manual has been the work of many authors, and particular thanks are due to the Members of the Subcommittee on Transfer Pricing—Practical Matters at the time of completion of the Manual:[5] Stig Sollund (Norway—Coordinator); Julius Bamidele (Nigeria); Giammarco Cottani (Italy); Nishana Gosai (South Africa); Mansor Hassan (Malaysia); Michael McDonald (USA); Sanjay Mishra (India); Harry Roodbeen (Netherlands); Marcos Valadão (Brazil); Shanwu Yuan (China); Joseph Andrus (OECD); Keiji Aoyama (University of Waseda, Japan); Carol Dunahoo (Baker & McKenzie, USA); Michael Kobetsky (Australian National University &

[4] OECD (2017). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Paris: OECD Publishing. Available from https://doi.org/10.1787/tpg-2017-en.

[5] Members as of October 2012, when the Manual was presented to the Committee for consideration. Members of the Subcommittee serve purely in their personal capacity. Accordingly, the references to countries (in the case of those in government service) or employers (in other cases) are for information only.

Melbourne University, Australia); Kyung Geun Lee (Yulchon Lawyers, Korea); Toshio Miyatake (Adachi, Henderson, Miyatake & Fujita, Japan); T.P. Ostwal (Ostwal and Associates, India); Jolanda Schenk (Shell, Netherlands); Caroline Silberztein (Baker & McKenzie, France); and Monique van Herksen (Ernst and Young, Netherlands).

Former Members of the Subcommittee who also contributed were Amr El-Monayer (Egypt); José Madariaga Montes (Chile); Carmen van Niekerk (South Africa); and Stefaan de Baets (OECD). Observers at various Subcommittee meetings provided valuable insights. Secretarial support for the Manual was provided by Michael Lennard, assisted in particular by Ilka Ritter.

Appreciation is expressed to the European Commission, particularly its Departments of Company Taxation Initiatives and of Budget Support, Public Finance and Economic Analysis, for making possible the valuable editorial work of Hafiz Choudhury, and to the Royal Norwegian Ministry of Foreign Affairs for additional support. The Subcommittee also expresses its gratitude to the relevant ministries and agencies of the governments of Malaysia, India, Japan, South Africa and the People's Republic of China for generously hosting Subcommittee meetings. Thanks are also due to those who made comments on the draft chapters.

While consensus has been sought as far as possible, it was considered most in accord with a practical manual to include some elements where consensus could not be reached, and it follows that specific views expressed in this Manual should not be ascribed to any particular persons involved in its drafting. Chapter 10 is different from other chapters in its conception, however. It represents an outline of particular country administrative practices as described in some detail by representatives from those countries, and it was not considered feasible or appropriate to seek a consensus on how such country practices were described. Chapter 10 should be read with that difference in mind.

To assist in understanding the practical application of transfer pricing principles, this Manual frequently refers to hypothetical examples, such as in relation to Chapter 5 on Comparability Analysis and Chapter 6 on Methods. Such examples are intended to be purely illustrative, and not to address actual fact situations or cases. Finally, it should be noted that this Manual is conceived as a living work that should be regularly revised and improved, including by the addition of new chapters and additional material of special relevance to developing countries. This will only improve its relevance to users and its significance as a work that can be relied upon in the capacity-building efforts of the United Nations and others that are so needed in this field.

Contents

Glossary

Term **Definition in UN Manual**

Adjustments See Transfer Pricing Adjustment.

Advance Pricing Arrangement (APA) An APA is an arrangement in respect of certain specified transactions that determines in advance the appropriate criteria for determining transfer pricing. The agreement may be made by the taxpayer unilaterally with the tax administration or may be a bilateral or multilateral agreement involving the tax administrations of other countries.

Affiliated parties Affiliated parties are entities linked by a common interest normally defined in terms of a certain level of shareholding or another criterion.

Allocation key An allocation key is used to allocate costs of a service provider among other related entities for the purposes of computing the arm's length fee under the cost plus method using an indirect charge approach. The allocation key may be a quantity such as turnover, employee numbers, working hours or floor space.

Arm's Length Principle (ALP) The ALP is an international standard that compares the transfer pricing charged between related entities with the price of similar transactions carried out between independent entities at arm's length. An adjustment may be made to the extent that profits of a related party differ from those that would be agreed between independent entities in similar circumstances.

Arm's length range The arm's length range is a range of values from which an arm's length price may be selected, arrived at by applying an appropriate transfer pricing method.

Artificial profit shifting The allocation of income and expenses between related entities or between branches of a single legal entity with the aim of reducing the total tax payable by the group.

Assembled workforce A business may assemble a uniquely qualified or experienced group of employees and this could affect the arm's length price for services provided or the efficiency with which goods or services are provided by the business. This should ordinarily be taken into account in the comparability analysis. The existence of an assembled workforce may also need be taken into account in pricing business restructurings or similar transactions.

Associated enterprises Associated enterprises are enterprises under common control. This will generally be the case where the same persons participate directly or indirectly in the management, control or capital of both enterprises.

Average When a transfer price is found to be outside the arm's length range the transfer pricing rules of some countries require the price to be adjusted to the average value (usually the median) of the range.

Basic Arm's Length Return Method (BALRM) The BALRM assigns an estimated arm's length rate of return to the sale, licensing or transfer of intangible property. The method was proposed in a White Paper in the US in 1988 but has not been adopted in the US transfer pricing legislation. Some aspects of the method are however present in the comparable profits method. The method focuses on the returns realized on the assets or costs used in performing each function by a related party, and examines the return of uncontrolled entities performing the same functions at arm's length.

Benchmarking Benchmarking in transfer pricing refers to the process of comparing the conditions of the related party transaction, referred to as the controlled transaction, with the conditions that apply to similar transactions carried out by independent unrelated parties in similar circumstances, referred to as uncontrolled transactions. Generally benchmarking involves a search in databases of company information to extract relevant uncontrolled transactions for comparison and analysis.

Benefit test In considering the arm's length return for intragroup services the benefit to the recipient of the services, if any, should be taken into consideration. If no benefit is received by the recipient of the services this would indicate that no remuneration should be paid for the services.

Berry ratio The ratio of gross income to operating costs, sometimes used to establish the arm's length price using the transactional net margin method.

Best method rule A rule requiring the taxpayer to use the transfer pricing method that results in the most reliable measure of the arm's length price in the circumstances. The rule does not give priority to the same transfer pricing methods in all circumstances.

Business restructurings The cross-border redeployment of functions, assets and risks by a multinational entity.

Centralized services Services performed by a headquarters or group service company on behalf of a number of entities in the group. Typical centralized services include accounting, legal, pensions, payroll or tax.

Commodity rule See "sixth method".

Comparability adjustments Adjustments made to improve the accuracy and reliability of the comparables to ensure that the financial results of the comparables are stated on the same basis as those of the tested party.

Comparability analysis An analysis carried out to compare the controlled transaction with the conditions that prevail in transactions at arm's length between independent entities. This involves an understanding of the economically significant characteristics of the controlled transaction and a comparison of the conditions of the controlled transaction with those of the comparable transactions.

Comparability factors Factors taken into account in determining the level of comparability of the controlled and comparable transactions. These are attributes of the transactions or parties that could materially affect prices or profits, including: the characteristics of the property or services; functional analysis; contractual terms; economic circumstances; and business strategies pursued.

Comparable adjustable transaction Controlled and uncontrolled transactions are comparable if either none of the differences between them could materially affect the arm's length price or profit or, where such material differences exist, reasonably accurate adjustments can be made to eliminate their effect. A comparable transaction to which such comparability adjustments can be made is a comparable adjustable transaction.

Comparable data These may be internal comparables, i.e. transactions between the tested party and independent parties, or external comparables, i.e. transactions between two independent entities that are not a party to the controlled transaction.

Comparable Profits Method Under the US transfer pricing regulations, the Comparable Profits Method is a method to determine an arm's length consideration for transfers of intangible property. If the reported operating income of the tested party is not within a certain range, an adjustment will be made. The method involves comparing the operating income that results from the consideration actually charged in a controlled transfer with the operating income of similar uncontrolled taxpayers.

Comparable search A comparable search involves the identification of potentially comparable transactions or companies. These may be internal comparables, i.e. transactions between the tested party and independent parties, or external comparables, i.e. transactions between two independent entities that are not a party to the controlled transaction. A search for external comparables involves consideration of the comparability factors; development of screening criteria; initial identification and screening; and secondary screening, verification and selection of comparable transactions.

Comparable Uncontrolled Price (CUP) Method The CUP Method is a transfer pricing method comparing the price of the property or services transferred in the controlled transaction with the price charged in comparable transactions in similar property or services in similar circumstances.

Comparable uncontrolled transaction A transaction between independent enterprises that is similar to the controlled transaction and takes place in similar circumstances.

Compensating adjustment A compensating adjustment is made by a taxpayer who reports an arm's length transfer price for a controlled transaction even though this price differs from the amount actually charged between the associated enterprises. This adjustment would be made before the tax return is filed.

Competent authority procedure Under a double tax treaty or other agreement the contracting states may each appoint a competent authority that is empowered to resolve disputes arising from the interpretation or application of the agreement. This mutual agreement procedure is provided for in the treaty or in another agreement such as the EU Arbitration Convention.

Conduit company An entity entitled to the benefit of a tax treaty in respect of income arising in a foreign country, in a situation where the economic benefit of that income accrues to persons in another country who would not have been entitled to the treaty benefits if they received the income directly rather than via the conduit company.

Connected persons In the context of transfer pricing, connected persons are associated enterprises to which transfer pricing laws and regulations may apply. Connected persons are defined in terms of the control of one person over the other or two persons under the control another person.

Contemporaneous documentation Transfer pricing documentation prepared at the time that the relevant transactions take place.

Contribution analysis Where a contribution analysis is used under the profit split method, the relevant profit from the transactions is divided between the associated enterprises based on the relative value of their contributions, e.g. their functions performed, assets used or contributed and risks assumed.

Control Control is defined for the purpose of the UN Model Tax Convention as a situation where one enterprise participates directly or indirectly in the management, capital or control of another; or where the same persons participate directly or indirectly in the management, capital or control of both enterprises.

Controlled Foreign Corporation (CFC) A CFC is a corporation normally located in a low tax jurisdiction and controlled by shareholders resident in another country. CFC legislation normally combats the sheltering of income in such corporations in low tax jurisdictions by attributing a proportion of the income sheltered in the corporation to the shareholders in the country where they are resident.

Controlled transaction Transactions between associated enterprises for the transfer of property or services. The term may also be used to denote a transaction between related enterprises which is the subject of a transfer pricing analysis.

Coordination centre An enterprise whose only purpose is to coordinate the activities of associated enterprises, to do research or to carry out support activities for those enterprises.

Correlative adjustment See corresponding adjustment.

Corresponding adjustment An adjustment made to the profits of an associated enterprise by the tax authority in a second jurisdiction, corresponding to a primary adjustment made by the tax authority in the first jurisdiction, so that the allocation of profits of the group by the two jurisdictions is consistent.

Cost Contribution Arrangement (CCA) A cost contribution arrangement (CCA) is an arrangement between enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights. The arrangement sets out the responsibilities and risks of the participants and the nature and extent of the interest of each participant in the assets, services or rights resulting from the arrangement.

Cost Plus Method (CPM) This method evaluates the arm's length nature of an intercompany charge for tangible property or services by reference to the gross profit mark-up on costs incurred by the supplier of the property or services. It compares the gross profit mark-up earned by the tested party with the gross profit mark-ups earned by comparable companies.

Cost Sharing Arrangement (CSA) A CSA is the term used in the US to describe a cost contribution arrangement between enterprises to share the costs and risks of developing intangible assets. The arrangement would normally set out the contributions of the participants and define their share in the results of the assets resulting from the arrangement.

Country-by Country (CbC) Report The final BEPS report on Action 13 (2015) on transfer pricing documentation included a country-by-country (CbC) reporting requirement for multinational groups that meet a specified turnover threshold to provide aggregate information on an annual basis covering the jurisdictions in which they operate. This gives details of entities, income and taxes paid in each jurisdiction and indicators of economic activity and substance.

Country file Under the EU code of conduct on transfer pricing documentation taxpayers are recommended to keep documentation including a country-specific file. This should contain: a detailed description of the taxpayer's business strategy; details of country-specific controlled transactions; a comparability analysis;

selection and application of a transfer pricing method; and internal and external comparables etc.

DAEMPE Analysis of transactions involving the use or transfer of intangible assets between associated enterprises requires identification of specific contributions made with respect to DAEMPE (development or acquisition, enhancement, maintenance, protection and exploitation) of the intangibles involved. Some or all of them might reflect important contributions to value that must be appropriately remunerated.

Delineation In the process of undertaking a transfer pricing analysis, the first step always involves the accurate delineation of the transaction, including an awareness of the industry and market context in which the transaction takes place.

Direct charge method A method of directly charging each recipient of intragroup services on a clearly identified basis, not involving apportionment of costs between recipients based on an allocation key.

Documentation requirements Documentation requirements relate to transfer pricing documentation that is required by the transfer pricing rules of a particular country. The required documentation may be listed in the law or regulations, or in some countries may not be specified in detail.

Duplicated services Duplication of services takes place when a service is provided to an associated enterprise which has already incurred costs for the same activity performed either by itself or on its behalf by an independent entity. Duplicated activities are usually not chargeable services although this must be decided on the facts and circumstances of each case.

EU master file The EU code of conduct on transfer pricing documentation recommends that the documentation of a multinational enterprise should consist of two main parts, a master file and a country specific file. The master file contains common standardised information relevant for all EU group members.

Fair market value The fair market value is the value that a particular asset or service would fetch on the open market on the assumption that adequate knowledge of the market is available to the buyer and seller, they are acting in their best interests without external pressures and a reasonable amount of time is allowed for the transaction to take place.

Formulary apportionment Under formulary apportionment a formula is used to apportion the group's net income between the various entities and branches in the group. The formula normally uses factors such as property, payroll, turnover, capital invested or manufacturing costs.

Functional analysis An analysis involving the identification of functions performed, assets employed and risks assumed with respect to the international controlled transactions of an enterprise. The functional analysis seeks to identify and compare the economically significant activities and the responsibilities undertaken by the independent and associated enterprises.

Gross profit The result of deducting from total sales the cost of sales, including all the expenses directly incurred in relation to those sales.

Group service centre A special department within a parent company or regional holding company, or any other associated enterprise within a multinational group such as a group services company, providing services to associated enterprises.

Group synergies Multinational groups and the associated enterprises that are parts of groups may sometimes benefit from interactions or synergies among group members that are not generally available to independent enterprises in a similar situation. These could arise for example from: combined purchasing power; economies of scale; integrated management; or increased borrowing capacity.

Hard-to-value intangibles Hard-to-value intangibles are intangible assets or rights in intangibles for which there are no reliable comparables at the time of their transfer between associated enterprises, and there is no reliable projection of future cash flows or income expected to be derived from the transferred intangible at the transfer date; or where the assumptions used in valuing the intangible are highly uncertain.

Head office expenses Expenses of the head office of a legal entity, some of which may relate to an overseas branch of the same legal entity.

Implicit support To the extent that a borrower that is a member of an MNE benefits from an improved credit rating solely on the basis of implicit support from the MNE, without an explicit guarantee, no payment would be required for the benefit.

Incidental benefits One associated enterprise may provide an intragroup service to another associated enterprise under circumstances where that service also incidentally gives rise to benefits being received by other members of the MNE group other than the primary beneficiary of the service. The determination of whether a service fee should be paid by the incidental beneficiaries of the service depends on the facts and on whether an independent party in the same circumstances would have been willing to pay for the service.

Indirect charge method A method under which fees for intragroup services are computed on the basis of apportionment of costs using an allocation key, with an appropriate mark-up.

Intangibles Intangibles are property that have no physical existence but whose value depends on the legal rights of the owner. Examples of intangibles are intellectual property such as patents, copyright and trademarks.

Intentional set-off A benefit provided by one associated enterprise to another that is deliberately balanced to some extent by different benefits received from that enterprise in return.

Interquartile range This term is used in the transfer pricing rules of some countries to describe the values between the 25th and 75th percentile of the range of arm's length results derived from application of a transfer pricing method. In some jurisdictions this range may be used as the arm's length range.

Internal comparables Transactions between one of the parties to a controlled transaction (taxpayer or related enterprise) and an independent party.

Intragroup services Services carried out by one entity in a multinational group for another entity or entities in the same group.

Joint International Taskforce on Shared Intelligence and Collaboration (JITSIC) The Joint International Taskforce on Shared Intelligence and Collaboration (JITSIC) has 42 member countries and provides a means for tax administrations to exchange information and engage in collaborative casework, within the framework of bilateral and multilateral conventions and tax information exchange agreements. Membership is open to all member countries of the OECD's Forum on Tax Administration (FTA).

Local file The final BEPS report on Action 13 (2015) on transfer pricing documentation included a reporting requirement that groups should prepare a local file containing details of related party transactions of the local taxpayer including a description of the transactions, a comparability analysis and the selection and application of transfer pricing methods.

Location rents Location rents are the incremental profits arising to a multinational group from location specific advantages in a particular location.

Location savings Cost savings or benefits such as cheaper production or service costs resulting from locating a manufacturing or other operation in a low-cost jurisdiction.

Location specific advantages The relocation of a business may, in addition to location savings, give some other location-specific advantages (LSAs). These LSAs could include: highly specialized skilled manpower and knowledge; proximity to a growing local/regional market; a large customer base with increased spending capacity; advanced infrastructure; or market premium.

Low value-adding services Low value-adding services are services of a supportive nature; not part of the core business of the group; not involving the use of, or leading to the creation of, unique and valuable intangibles; and not involving the assumption or creation of significant risk for the service provider. The BEPS recommendations suggest that a group could elect to use a simplified method for low value-adding services covering all the countries in which it operates.

Marketing intangibles Intangibles relating to marketing activities, aiding in the commercial exploitation of a product or service or with important promotional value for a product or service.

Master file The final BEPS report on Action 13 (2015) on transfer pricing documentation included a reporting requirement for groups to prepare a master file to supply general information on the group of which the taxpayer is a member, including a description of the group and its organizational structure, a description of its business, intangibles employed, intragroup financial activity and the financial and tax position of the group.

Median The median value is the value at the mid-point of the arm's length range. Transfer pricing rules sometimes provide that a transfer price that is outside the arm's length range should be adjusted to the median value of the range.

Multiple year data Data in respect of the controlled and comparable transactions covering a number of years.

Mutual Agreement Procedure (MAP) A procedure by which the competent authorities of contracting states consult with a view to resolving disputes over the application of double tax conventions. This procedure may be used to eliminate double taxation arising from a transfer pricing dispute.

Multinational enterprises (MNEs) An MNE is an enterprise with integrated business operations in more than one country, generally operating across international borders through locally incorporated subsidiaries, permanent establishments or other types of legal structure such as joint ventures.

Non-recognition The term "non-recognition" refers to a situation where the tax administration does not accept the taxpayer's characterization of a transaction and therefore disregards the transaction. In general, non-recognition or substitution of transactions by the tax administration should not be undertaken lightly as this would create significant uncertainty for the taxpayer and the tax administration. It may also lead to double taxation due to the divergent views taken by countries on how any substitute transactions are structured.

OECD Transfer Pricing Guidelines Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD, 1995. The OECD Guidelines are regularly amended and updated.

Operating profits The net income of a company after deducting direct and indirect expenses but before deductions for interest and taxes.

Passive association Benefits to members of an MNE may arise as a result of an associated entity's membership of the MNE. Such benefits are attributable to the entity's passive association with the MNE and are not normally a chargeable service for member entities of the MNE. For example, independent enterprises transacting with an enterprise that is a member of an MNE group may be willing to provide goods or services to it at prices that are below the prices charged to independent buyers.

Permanent establishments (PEs) Permanent establishment refers to a concept under bilateral tax treaties that establishes whether a company has a "footprint" in a jurisdiction and would thus be liable for corporate income tax attributable to the PE.

Platform for Collaboration on Tax (PCT) The PCT is a joint initiative of the International Monetary Fund (IMF), the Organization for Economic Co-operation and Development (OECD), the United Nations, and the World Bank Group to strengthen collaboration on domestic resource mobilization (DRM).

Presumptive taxation Presumptive taxation provisions give tax authorities the power to presume an arm's length price based on information gathered by the authorities, and to reassess the taxpayer's taxable income on that basis. Such provisions are generally only regarded as applicable in case of the taxpayer's failure to provide relevant documentation on the arm's length price within a reasonable time. Presumptive taxation is usually provided for as a last resort.

Primary adjustment An adjustment made by a tax administration to a company's taxable profits as a result of applying the arm's length principle to transactions involving an associated enterprise in another tax jurisdiction.

Profit Split Method (PSM) This method seeks to eliminate the effect on profits of non-arm's length conditions made or imposed in controlled transactions by determining the division of profits that independent enterprises would have expected to realize from engaging in the transactions.

Profit Level Indicator (PLI) A measure of a company's profitability that is used to compare comparables with the tested party. A PLI may express profitability in relation to (i) sales, (ii) costs or expenses, or (iii) assets.

Related parties Related parties are entities under common management, control or ownership, or where one entity controls the other entity.

Resale Price Method (RPM) This method analyzes the price of a product that a related sales company charges to an unrelated customer, i.e. the resale price, to determine an arm's length gross margin that the sales company retains to cover its sales, general and administrative expenses and still make an appropriate profit.

The remainder of the product's price is regarded as the arm's length price for the transactions between the sales company and a related party.

Residual analysis Where a residual analysis is used under the profit split method, the relevant profits in relation to the transactions are allocated between the associated enterprises based on a two-step approach. In the first step, a "routine" arm's length profit for the basic or "routine" contributions of each enterprise is determined, e.g. through the application of a one-sided method using information from uncontrolled transactions. In the second step, the residual profit remaining after deducting those "routine" returns is split between the enterprises, generally based on their relative contributions.

Roll-back Under certain circumstances an advance pricing agreement (APA) in respect of future tax years may be rolled back and used as an appropriate transfer pricing method for past open tax years, considering all facts and circumstances.

Rulings A ruling or advance ruling is a written statement issued to the taxpayer by the tax authorities interpreting and applying the tax law to a specific set of facts.

Safe harbour A provision in the tax law, regulations or guidelines stating that transactions falling within a certain range will be accepted by the tax authorities without further investigation.

Secondary adjustment An adjustment that arises from imposing tax on a secondary transaction. A secondary transaction is a constructive transaction that may be asserted in some countries after making a primary adjustment, in order to make the actual allocation of profits consistent with the primary adjustment. Secondary transactions may take the form of constructive dividends, constructive equity contributions or constructive loans.

Secret comparables This generally refers to the use of information or data about a taxpayer by the tax authorities to form the basis of transfer pricing scrutiny of another taxpayer, who is often not given access to that information, because for example it may reveal information about a competitor's operations.

Shareholder services Services performed by a member of a multinational group (usually the parent company or a holding company) in its capacity as a shareholder, for example preparation of consolidated accounts.

Shifting of profits Allocation of income and expenses between related corporations or branches of the same legal entity in order to reduce the overall tax liability of the group or corporation.

Sixth method The "sixth method" or commodity rule is an approach used in certain countries of Latin America and elsewhere, and requires commodity market quoted prices of imported or exported goods at a specified date to be used to compute the transfer price. There are considerable variations both in the scope of the rule and its application.

Small and medium enterprises (SMEs) SMEs may be defined in the general tax or transfer pricing legislation of a country as enterprises that are below a certain threshold amount of assets, turnover, employee numbers etc. An SME operating in two or more countries may need to comply with the transfer pricing legislation, but some countries have introduced simplified transfer pricing rules for SMEs such as simplified documentation requirements.

Tested party The tested party is the party in relation to which a financial indicator (e.g. mark-up on cost, gross margin or net profit) is tested when using the cost plus, resale price or transactional net margin methods.

TNMM See Transactional Net Margin Method.

Trade intangibles Trade intangibles are commercial intangibles other than marketing intangibles. Examples of trade intangibles are patents or copyrights.

Transactional Net Margin Method (TNMM) This Method examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction. This is compared to the net profit margins earned in comparable uncontrolled transactions.

Transfer pricing The general term for the pricing of cross-border, intra-group transactions in goods, intangibles or services.

Transfer pricing adjustment An adjustment made by the tax authorities to the profits of an enterprise after determining that the transfer price of a transaction with a related party does not conform to the arm's length principle.

Transfer pricing method A transfer pricing method is a methodology by which the arm's length principle is applied to determine the arm's length price of a transaction. Examples of transfer pricing methods are the comparable uncontrolled price method, resale price method, cost plus method, transactional net margin method and profit split method. Other appropriate methods are also used in some jurisdictions.

Uncontrolled transaction A transaction between independent and unrelated enterprises.

Value chain The process or the activities by which a company adds value to goods or services, including production, marketing, and the provision of after-sales service.

Part A

TRANSFER PRICING IN A GLOBAL ENVIRONMENT

1 Multinational Enterprises

1.1 Introduction

1.1.1 Transfer pricing rules apply primarily to the cross-border business operations of multinational enterprises ("MNEs"). MNEs are firms that conduct integrated business operations in more than one country. This chapter describes the factors that gave rise to MNEs in an attempt to provide the reader with the basic business context for the detailed transfer pricing discussion that will follow in the rest of this Manual. This chapter shows how an MNE may be able to exploit integration opportunities in the cross-border production of goods and provision of services through a "value-chain" (or "value-added chain"). As used in this Manual, the term "value chain" refers to the process or activities by which a company adds value to a good or service, including production, marketing, and the provision of after-sales service.

1.1.2 MNEs generally operate across international borders through locally incorporated subsidiaries or permanent establishments. They may also use other legal structures such as joint ventures and partnerships. An MNE's business operations may be organized and managed in several different ways such as through a functional structure, a divisional structure or a matrix structure. This chapter outlines the legal and operational structures that may be used by MNEs, and considers the differences between them.

1.1.3 This chapter also describes how a "value chain analysis" can be used to measure or test the performance of an MNE. An MNE manages its business to maximize its profits and minimize its costs. It manages its transfer pricing function to minimize the risk of transfer pricing adjustments and to avoid double taxation. While MNEs often monitor the overall performance of their business operations on a line of business basis without regard to national borders, for tax and company law purposes they are often required to separately report the performance of associated entities in each of the countries in which they operate. An MNE's transfer pricing policy helps the group to report on a separate country basis and should provide guidance on how the group will comply with transfer pricing documentation requirements, how it will report the results of operations in its tax returns, how it will deal with transfer pricing audits conducted by local tax authorities, and the appropriate measures the group will utilize to resolve any disputes with tax authorities that may arise.

1.2 Development of Multinational Enterprises

1.2.1 Firms are organizations that arrange the production of goods and the provision of services. The aim of a firm is to produce goods and provide services to maximize profits. In the absence of MNEs, production and distribution would be carried out through a series of arm's length transactions between independent parties[6]. These transactions require contracts between the independent parties to transactions, but a significant part of each individual firm's resources are used in the process of making contracts. Individual firms become MNEs as these firms grow, expand and diversify their operations internationally. Rapid advances in technology, transportation and communications have given MNEs the flexibility to place their enterprises and activities almost anywhere in the world.

1.2.2 The expenses of making contracts is referred to as "transaction costs" since expenses are incurred by entities in finding other entities with whom to contract, as well as in negotiating and finalizing the contracts. As contracts cannot cover every possible issue that may arise between contracting parties, there is a risk of disputes arising from unforeseen contingencies. When disputes occur between contracting parties, those parties may incur considerable costs in resolving these including negotiation costs, legal expenses, and litigation and mediation expenses. It is economically rational for MNEs to be created to produce goods and services to achieve efficiencies in scale in transaction and associated costs, provided that the MNE's costs of production are less than the costs of outsourcing the production.

1.2.3 Within an MNE, contracts between the various parties involved in production of goods and services may be eliminated and replaced with administrative arrangements; in other cases, the group members within the MNE may enter into formal contracts The administrative costs of organizing production within an MNE are usually lower than the cost of the alternative, which is outsourcing market transactions. The theoretical limit to the expansion of an MNE is the point at which its costs of organizing transactions are equal to the costs of carrying out the transactions through the market. An MNE will

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[6] UNCTAD (1993). *World Investment Report: Transnational Corporations and Integrated Production*. New York: UN Publishing. Available from https://unctad.org/system/files/official-document/wir1993_en.pdf; Coase, R. (1988). *The Firm, the Market and the Law.* Chicago: University of Chicago Press. See p. 7.

internalize the costs of production to the extent that it can achieve economies of scale in production and distribution and establish coordination economies.

1.2.4 MNEs create organizational structures and develop strategies to arrange the cross-border production of goods and services in locations around the world, and to determine the level of intra-entity or intragroup integration. The structure of transactions within an MNE is determined by a combination of market and group forces which can differ from open market conditions between independent parties. A large number of international transactions within MNEs are therefore not governed directly by market forces but driven by the common interest of the MNE.

1.2.5 Successful MNEs use their location and internalization advantages to maximize their share of global markets and growth opportunities. Thus, MNEs may be able to minimize costs through their integration economies; such economies are not available to domestic firms.

1.2.6 A key feature of MNEs is that they have integrated global supply chains. A supply chain is a collection of suppliers required to create one specific product or service for a company. Each supplier is a link in the end-to-end supply chain. If those links/enterprises are under common control, the enterprises may be considered as "associated enterprises". The term "supply chain" is defined as "the sequence of processes involved in the production and distribution of a commodity."[7] The process of running and improving the efficiency of the supply chain for the benefit of most, if not all, of the links in the supply chain, can be a feature of the value chain of the MNE.

1.2.7 Globalization has made it possible for an MNE to achieve high levels of integration and the ability to have control centralized in one or a few locations. Modern information and communications systems also facilitate communications across geographic and functional business lines. This has resulted in many MNEs providing services such as advisory, research and development (R&D), legal, accounting, financial management, and data processing from one or several regional centres to group companies. Also, management teams of an MNE can be based in different locations, so that the group may have management resources dispersed in several locations. From the economic perspective of the MNE, these resources need to be allocated with maximum efficiency and in an optimal manner, in order to contribute to an optimal value chain.

1.2.8 International business has experienced far-reaching structural change with the rise of service and knowledge-intensive industries and, with

[7] The Oxford English Dictionary. Oxford: Clarendon Press. Available from https://www.lexico.com/definition/supply_chain

the expansion of the internet economy, service and technology enterprises are playing an increasingly important role in the international marketplace.

1.2.9 In the past MNEs mostly operated in physical markets and through presence in multiple jurisdictions. However, the current pace of digitalization of the economy enables some MNEs to conduct significant business in places where they do not have any physical presence. This makes addressing the taxing rights of the respective countries to avoid double or non-taxation particularly challenging.

1.2.10 The rapid evolution in MNEs is also reflected in the rise of many developing economies where foreign investments have grown significantly. In developing countries, MNEs have diversified well beyond primary production and extractive industries into manufacturing, assembly, domestic market development and services, utilizing transport and other infrastructure, skilled labour and low production costs.

1.2.11 The activities of MNEs, through international trade and investment, have strengthened and deepened the ties that join countries in an increasingly interdependent world. These activities can bring substantial benefits to both home and host countries. These benefits accrue when MNEs supply the products and services that customers want to buy at competitive prices and when they provide fair returns to the suppliers of capital. Their trade and investment activities can contribute to the efficient use of capital, technology and human and natural resources.

1.2.12 MNEs have common control, common goals and common resources, and the members of the group — parent/HQ company, subsidiaries, affiliates and branches — are located in more than one country. Thus, many MNEs are fully integrated businesses that plan and implement global strategies. UNCTAD has noted, however, that integration of production by MNEs creates challenges for policymakers in adapting the methods for allocating the income and costs of MNEs between jurisdictions for tax purposes.[8]

1.2.13 In *Multinational Enterprises and the Global Economy* (2008)[9] the authors argue that the history of MNEs was shaped by political, social and cultural events that influenced the ownership, organization and location of international production of their goods and services. The authors claim that MNE groups tended to

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8 UNCTAD (2019). *Trade and Development Report 2019*. New York: UN Publishing. Available from https://unctad.org/system/files/official-document/tdr2019ch1_en.pdf

9 Dunning, J. H., & Lundan, S. M. (2008). *Multinational Enterprises and the Global Economy*. Cheltenham: Edward Elgar Publishing. See p. 197.

integrate their operations until the late 1980s and then more recently moved to outsource some activities in which they do not have competitive advantages.

1.2.14 For most of the twentieth century, the same authors note, MNE groups and international enterprises operating through branches or subsidiaries tended to expand the range of their value-adding activities, and by the late 1980s MNEs had integrated their production and marketing functions. Up to the 1960s and 1970s, MNEs engaged in limited or no outsourcing of operations and many became large integrated conglomerates. However, the authors argue that from the late 1980s MNEs began outsourcing activities that were previously performed by the companies themselves.[10] From the early 1990s, MNEs began restructuring to specialize in the areas where they had competitive advantages, such as unique, firm-specific assets, in particular high value intangible assets, and the capabilities that provided the firms with their market position and competitive edge.

1.2.15 MNEs examined their value chains to identify the functions in which they had no advantage over other firms.[11] They then began deciding which functions they would perform themselves and which functions could be outsourced to independent firms or centralized shared service centres, a process called "value chain optimization". For in-house services, an MNE may decide to provide some services through centralized service centres. While the initial functions that were outsourced were non-core activities such as payroll, billing and maintenance services, in some cases outsourcing has expanded to cover core activities. The core activities may involve producing goods or providing services. For example, many firms outsource call centre activities or certain administrative functions to (in)dependent firms in countries which have educated workforces and relatively low-cost labour. Consequently, modern MNEs organize their cross-border operations through a network of contractual arrangements with (in)dependent enterprises and cooperative in-house relationships.

1.2.16 MNEs vary in size and include some small and medium-sized enterprises (SMEs). When SMEs commence operating in other jurisdictions through locally incorporated subsidiaries, they will usually need to comply with transfer pricing rules. Some SMEs may face challenges in this regard because they lack expertise with international tax issues in general and have limited compliance resources. These considerations may hinder them from expanding their operations abroad.

[10] Ibid, p. 196.

[11] Ibid.

1.2.17 Consequently, domestic transfer pricing rules which apply to SMEs should reflect the capacity of SMEs to comply and the capacity of the tax authorities to administer such rules. Some countries may have special simplified rules for SMEs, such as simplified documentation requirements, and may use flexible approaches in handling transfer pricing issues involving SMEs. This creates the need to define an SME. Although there is no universal definition, an SME may be defined on the basis of criteria including: turnover; balance sheet value; number of employees; and transaction values.

1.3 Corporate Structures of MNEs

1.3.1 General Principles of Company Law

1.3.1.1 The legal systems used by countries include the common law and civil law systems. The common law system originates in the UK and is used in Commonwealth countries such as Australia, Canada, India, Malaysia, New Zealand, and is also used in the majority of states in the United States. Common law originated in the practices of the courts of the English kings after the Norman Conquest, and is derived from custom and judicial precedent rather than statutes. This system spread through the British Empire to its then colonies, many of which retain the common law system today. These are legal systems that give great weight to judicial precedent, and to the style of reasoning inherited from the English legal system. A judgment of a superior court is binding on lower courts in future cases.

1.3.1.2 The civil law system has its origins in Roman law and operates in most European countries, Latin America and Japan. Under a civil law system, law is enacted and codified by parliament. Companies are recognized under both systems as artificial legal persons with perpetual life and generally limited liability.

1.3.1.3 One of the key decisions any MNE needs to take when expanding its operations is the type of legal structure it will use to operate. There are many alternatives for an MNE to operate either through locally incorporated subsidiary companies (associated enterprises) or else through permanent establishments (branches). Subsidiaries may be either fully owned by the parent company or partly owned. An MNE may also operate by using an agent, which may be an independent agent, a dependent agent or a commissionaire. Other alternatives may be expanding via a partnership or a limited liability partnership. Depending on domestic law in the investee jurisdiction, partnerships may be treated for tax purposes as fiscally transparent entities with flow-through treatment; alternatively, they may be treated as taxable entities.

1.3.1.4 MNEs can also carry on their business through a joint venture. Joint ventures involve independent businesses (which could themselves be incorporated entities, branches or partnerships) working together on a specific project. Joint venture partners can include a government agency or an entity that is normally a competitor (subject to competition policy/ antitrust rules).

1.3.1.5 The choice of an MNE's legal structure may be affected by a number of factors. The tax implications of a particular legal structure may be important. Other equally relevant considerations include issues related to legal liability, risk and control, financing concerns, and administrative and regulatory obligations and costs. In addition, exchange controls, "partnerability" (i.e. how well an entity is set up and managed to operate as a partner with others), "bankability" (i.e. having sufficient profit, assets, and liquidity to get a loan at a bank), requirements for minimum shareholding by local persons or entities, issues related to extraction of profits and capital requirements may all affect the selection of a legal structure.

1.3.1.6 Legal structures used by MNEs vary and evolve over time. The business structures used by an MNE group may similarly change over time such as, for example, commencing operations in a jurisdiction using a joint venture structure and then buying out the joint venture partner and operating in that jurisdiction through an associated enterprise.

1.3.1.7 In an MNE, the parent company and subsidiary companies are separate legal entities and they may enter into intragroup transactions. On the other hand, an international enterprise with a head office in one country and a permanent establishment in another country is considered one legal entity. As such a permanent establishment itself cannot enter into transactions with other parts of the enterprise in a formal, legal sense since transactions typically require at least two legal entities.

1.3.1.8 Company law determines how corporate entities are governed in many respects. "Corporate authorities", the powers exercised by various officers of an entity, originate from the respective legal authorities accorded to entities within the MNE. The Board of Directors has the authority to exercise all of the corporation's powers; and it delegates authority to act to certain company officers in certain circumstances. This includes delegating powers locally in accordance with local legal entities' requirements. The execution of a corporate authority binds the legal entity and consequently delegates must be aware of local legal and tax cross-border requirements as company and/or personal liability may arise as a result of the execution of such an authority.

1.3.1.9 Corporate and tax laws view corporations as separate entities. That is, parent companies, subsidiaries and affiliates are all legally distinct from each other. The separate existence of the subsidiary may be manifested, for example, in having its own properly constituted management, its own business purpose and its own assets appropriate to that purpose.

1.3.1.10 The boards and management of subsidiaries continue to hold fiduciary duties to control and manage the assets of, and to govern and manage the operations of, their respective subsidiaries and are not required to implement a shareholder request if implementation conflicts with those fiduciary duties (e.g. if the request contravenes local law).

1.3.1.11 "Organizational authorities" are the risk-based approval hierarchies that ensure operations are executed in accordance with internal business process and control requirements of the MNE. They are delegated from the Board of Directors down the chain of command. Organizational authorities can be executed across country borders as they do not create or constitute a legal commitment.

1.3.1.12 Corporate separateness is the concept of maintaining separate legal entities within the MNE, each subsidiary having its own separate legal identity and Board of Directors. While this does not mean that group companies must be treated as if they were wholly detached from the head office or its requests, it does mean that the boards and management of subsidiaries continue to hold fiduciary duties to control and manage the assets of, and to govern and manage the operations of, their respective subsidiaries. Organizational authorities can be considered as an advice to the separate legal entities and their boards. The corporate authorities in the end are the decision-making powers that legally bind the legal entities.

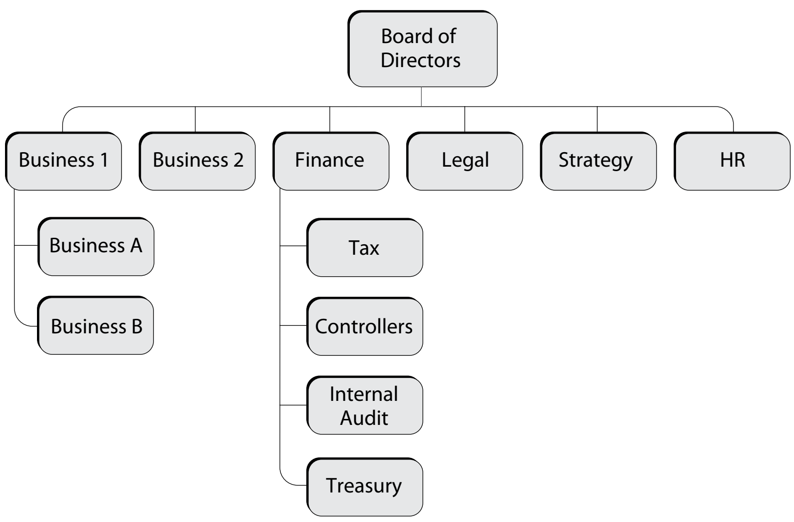
1.3.2 Management and Organizational Structures

1.3.2.1 In order to be able to perform a transfer pricing analysis it is crucial to understand how the management of the MNE is organized and what framework exists for decision-making. Ultimately an analysis of MNE decision making may provide useful context in determining risk assumption and control of important functions. It is important to understand that the management structure of the MNE may or may not be fully aligned with the legal structure. A particular legal entity in the MNE may house employees that function in various operational divisions or various management teams. Similarly, a management team or division may draw on people or use assets housed in several different legal entities.

1.3.2.2 The management or organization structure is used to outline and direct how people and resources are used to achieve the MNE's objectives. Finding the optimal arrangement requires adjustments at many levels. Some organizational structures may be more rigid than others. Some may define tasks, competencies and responsibilities, and establish the patterns or relationships between positions more rigidly, while others may be more fluid. There are a number of different types of organizational structures (discussed below) including the traditional ones, functional, divisional and matrix models. However, with the rapid development of the digitalized economy, a new organizational model is on the rise: a decentralized model based on a "network of teams", the lateral structure.

1.3.2.3 In a **functional structure** an MNE's functions are performed by the employees within functional divisions. These functions are usually specialized tasks, for instance all the accountants, controllers and tax advisors are grouped together in a finance function based on their speciality. In general, a functional organization is best suited to a producer of standardized goods and services at large volume and low cost to exploit economies of scale. Coordination and specialization of tasks are centralized in a functional structure, which makes decision making quicker, because the group members of a function can easily communicate as they have the same background.

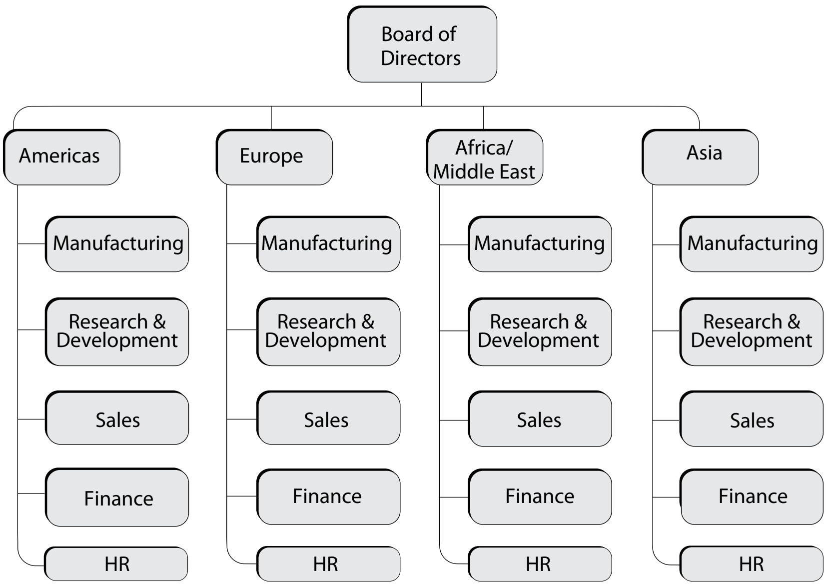
Figure 1.D.1
Functional Organization Structure



1.3.2.4 Under a **divisional structure**, each organizational function is grouped into a division with each division containing all the necessary resources and functions within it, such as human resources and accounts. Divisions can be categorized from different points of view. The distinction could for example be made on a geographical basis (e.g. a China division or a

West Africa division) or on a product/service basis (e.g. different products for different customers: households or companies). For example, an automobile company may have a divisional structure with a division for hybrid cars and another division for other cars with each of these divisions having its own sales, engineering and marketing departments.

Figure 1.D.2
Divisional Organization Structure



1.3.2.5 The **matrix structure** combines elements of the functional and divisional model, and is therefore more complex. It groups people into functional departments of specialization and then further separates them into divisions. A matrix organization frequently uses teams of employees to accomplish tasks. An example of a function-geographic matrix structure would be a company that produces two types of products (A and B) in several geographic locations. Using the matrix structure, this company would organize functions within the company as follows:

1.3.2.6 In the **lateral structure**, which as noted above is becoming more common, MNEs build and empower teams to work on specific business projects and challenges. Groups and departments work together at the same organizational level to achieve common goals. This type of structure depends on having collaborative and informal relations and requires coordination and consultation often through a matrix model. In today's digital economy there is a growing trend towards technology-enabled team-based lateral organizations where teams can take agile decisions.[12]

Figure 1.D.3
Matrix Organization Structure

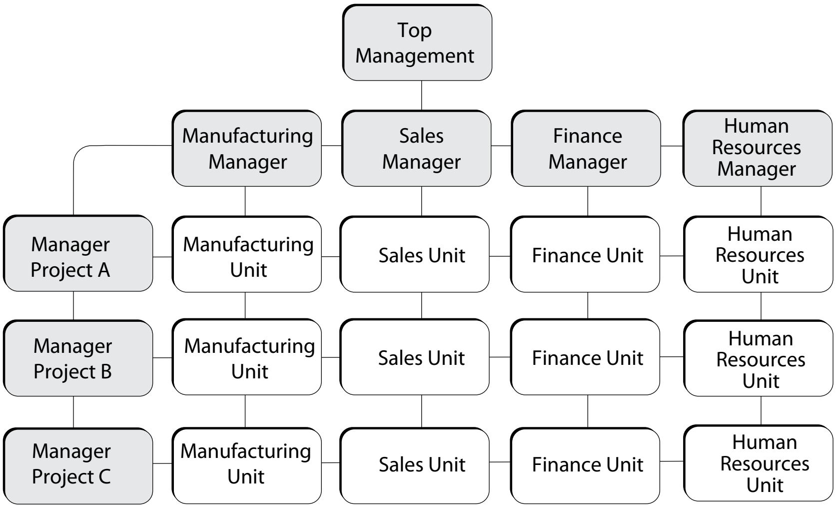
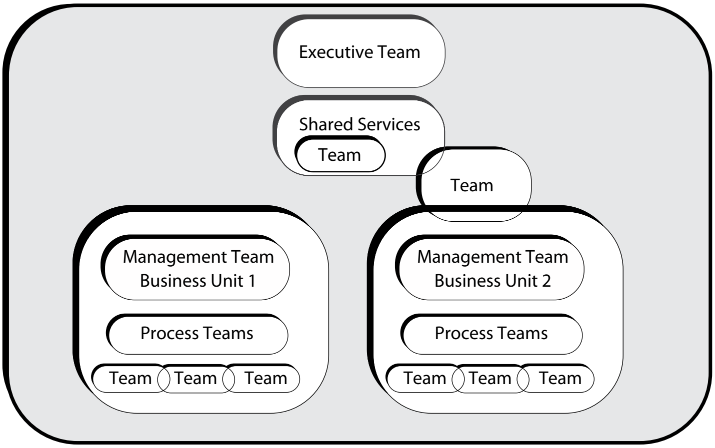


Figure 1.D.4
Lateral Organization Structure



Source: Mohrman, S. A., & Quam, K. (2000). Consulting to Team-based Organizations: An Organizational Design and Learning Approach. *Consulting Psychology Journal: Practice and Research, 52(1), 20.*

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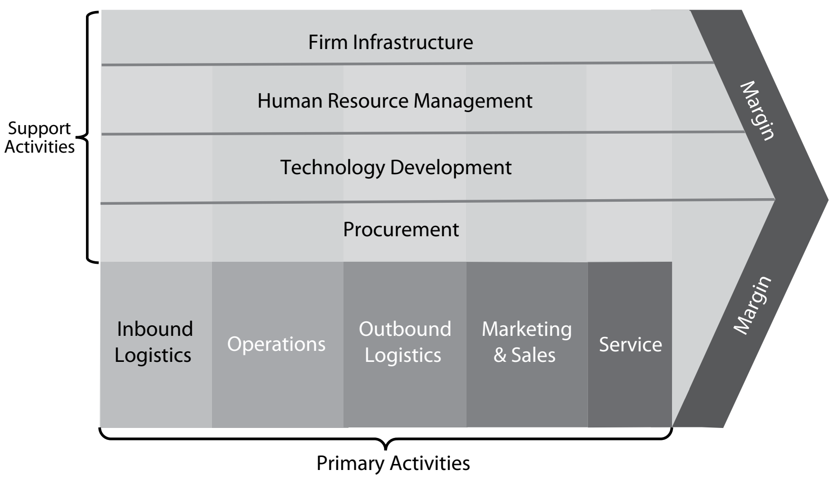
12 Holbeche, L. (2018). *The Agile Organization: How to Build an Engaged, Innovative and Resilient Business.* London: Kogan Page Publishers.

1.3.3 Value Chain Analysis

1.3.3.1 The aim of an MNE is to maximize its profits from producing and selling goods and services. A useful starting point to understand how an MNE operates is to perform a business value chain analysis. As noted above, a business value chain is the linked set of activities that the business performs to create value. These activities will be performed by various organizational units and legal entities within the business which together create the value that contributes to the overall profitability. As illustrated, for example, in Porter's value chain (see Figure 1.D.5 below):

Figure 1.D.5
Value Chain Analysis



Source: Porter, M. E. (1985). Competitive Advantage: Creating and Sustaining Superior Performance. New York: The Free Press.

1.3.3.2 Therefore, a value chain analysis should provide qualitative insight into a functional analysis. The value chain analysis is important in assessing intragroup pricing since the value chain identifies the key aspects of an organization that create value, and hence, profits. The value chain analysis involves an investigation into the functions, assets and risks of the MNE as a whole and an evaluation of the contribution each link of the chain makes to the overall value created by the group. Value chain analysis is not an easy task, especially for an MNE with complex function and risk matrices spread across different legal entities.

1.3.3.3 An MNE's value chain is fundamentally used to convert its economic resources of lower value into economic resources of higher value, which may involve the following steps:

(1) Mapping out a generic value chain for the industry;
(2) Mapping out an MNE's specific value chain;
(3) Comparing the generic value chain to the group's value chain and analyzing the differences which may explain why an MNE has a competitive advantage over its competitors;
(4) Distinguishing between an MNE's main functions and its support functions;
(5) Identifying and understanding which of the MNE's main functions are critical to the success of the organization (i.e. a critical success factor);
(6) Identifying and understanding which activities performed by an MNE add value to the goods and services it produces, and which activities distinguish the MNE from its competitors, i.e. value-adding activities; and
(7) Understanding and confirming how the various functions across the value chain are split by the MNE between its various constituent legal entities.

1.3.3.4 The following example shows how three different MNEs could adopt different operational structures in relation to the same generic value chain. Some possible reasons or context for these structures being used are discussed further below.

MNE A uses three different companies to perform very specific functions across the value chain as follows:

Company 1 in Country A is an R&D company carrying out research and also undertaking activities relating to the design of products for the entire group. A company of this nature would employ technical personnel such as engineers and scientists.

Company 2 in Country B is a fully-fledged manufacturing company (i.e. not a limited-risk contract manufacturer, for example) and also performs some functions related to the design and practical application of its products.

Company 3 in Country C is responsible for the marketing, distribution and after-sales service functions of the group.

MNE B uses two subsidiaries which perform some of the functions across the value chain and the group also outsources some of the activities to third parties:

Company 1 in Country A is an R&D company and carries out all the research and design activities in relation to the company's products. This company is similar to Company 1 of MNE A, apart from the fact that the design function is fully located in Company 1 and not partly carried out by Company 2.

Company 2 in Country B is the company responsible for marketing and customer service. This company is therefore the customer interface for the group. The MNE has decided to outsource the production and distribution functions to third-party companies.

MNE C uses three companies to perform the same functions in different geographical locations using intangibles developed by a third party, which would typically be used by the group under licence.

1.3.3.5 In addition to understanding the value chain of an MNE, it is also important to understand the context in which each of the companies within the MNE contributes to the value chain, as this will ultimately be relevant in analyzing the transfer pricing implications of the value chain.

1.3.3.6 For example, in MNE A's structure noted above (see Figure 1.D.6 below) the same basic value chain is defined as Company 1 performing R&D, Company 2 manufacturing, and Company 3 distributing the MNE's products. At first sight, then, the companies appear to be performing the same functions, but a deeper analysis is required to understand whether they are indeed the same. The context in which these activities are performed may be different depending on the legal and contractual arrangements between the companies.

1.3.3.7 One possible context could be that Company 1 performs R&D at its own risk, and is the legal owner of any intangible property developed through that R&D; Company 2 acts as a limited-risk contract manufacturer through a contractual arrangement with Company 1, and Company 3 acts as a limited-risk distributor through a contractual arrangement with Company 1. In this case, Company 1 is the legal owner of the intangible property of the MNE, and bears substantial risk associated with the manufacturing and sales of the MNE's products.

1.3.3.8 A different possible context for exactly the same basic value chain could be that Company 1 performs R&D on a contract basis for Company 2, which is the legal owner of any intangible property developed through that R&D; and Company 3 acts as a limited risk distributor through a contractual arrangement with Company 2. In this case, Company 2 is the legal owner of the intangible property of the MNE, and depending on the details of the functional analysis, may be treated as bearing substantial risk associated with the manufacturing and sales of the MNE's products.

1.3.3.9 A different possible structure relating to the same basic value chain could be that Company 1 performs R&D on a contract basis for Company 3, which is the legal owner of any intangible property developed through that R&D; and Company 2 acts as a limited risk contract manufacturer through a contractual arrangement with Company 3. In this case, Company 3 is the legal owner of the intangible property of the MNE, and depending on the details of the functional analysis, may be treated as bearing substantial risk associated with the manufacturing and sales of the MNE's products.

1.3.3.10 These three different contexts are illustrated in the following diagram. As will be discussed in subsequent chapters, each of these different contexts would very likely result in different transfer pricing outcomes.[13]

1.3.3.11 Broadly speaking, MNEs' business models range from decentralized to centralized. There is no "one size fits all" solution. Under a decentralized model, all separate business units (or legal entities) are self-contained, and they typically only rely on limited services from the head office. In such a model, local sales departments will be responsible for the full range of sales activities, from business planning, marketing, customer acquisition, sales and after sales, warehousing and distribution. Most risks associated with the sales, including market risks and credit risks, will usually be assumed by the local sales company under this type of structure.

1.3.3.12 The head office, in these models, generally provides high level "steerage" or strategic direction. Similarly, local manufacturing departments will usually be responsible for selecting raw materials, inventory management, facility maintenance and optimization, running the plant, and selling

[13] Contractual arrangements are not simply taken at face value by tax authorities. For example, each of these different possible contexts of MNE A's value chain would be subject to evaluation to ensure that the economic substance of the arrangements is consistent with the legal form of the arrangements, and that the terms of the arrangements are at arm's length.

the manufactured products to the entities performing the sales function. Entities often perform multiple functions, such as manufacturing, sales, marketing, R&D and supporting functions.

Figure 1.D.6
Example: How Different Groups Could "Customize" the Generic Value Chain

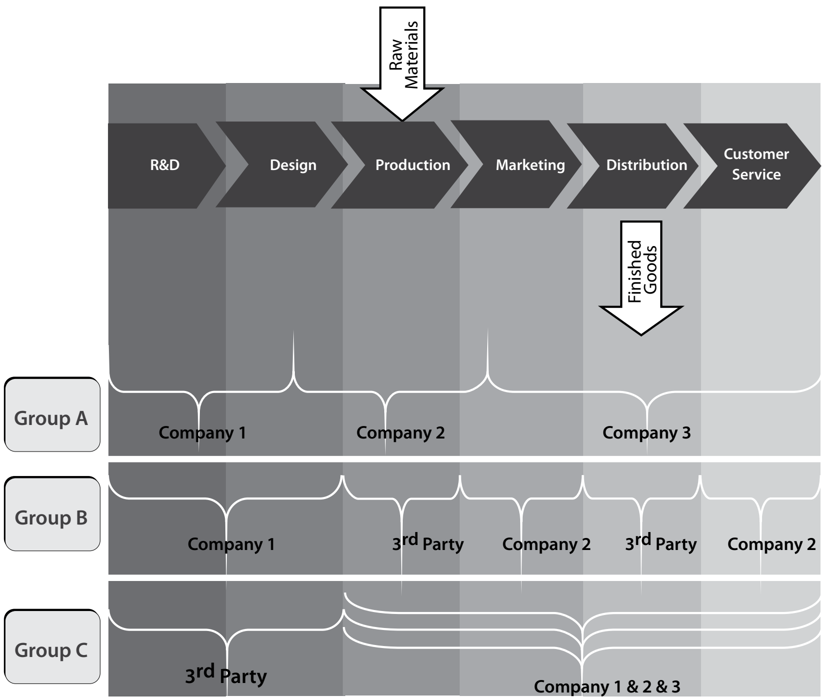
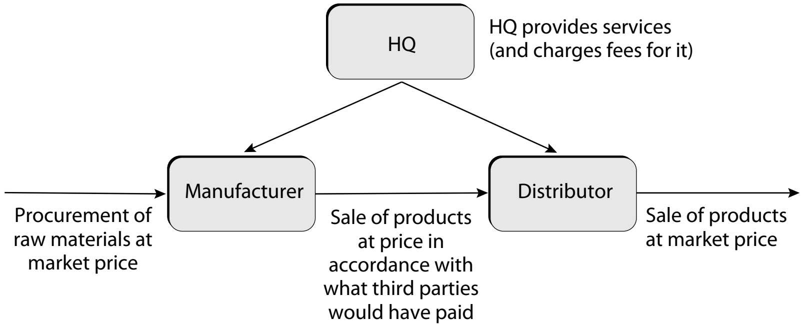


Figure 1.D.7
Example of a Decentralized Business Model

- Negotiated price between manufacturer and distributor, based on arm's length evidence
- Manufacturer and Distributor largely run as autonomous businesses (in reality, often in same legal entity)
- Only HQ makes predictable return, for its services to the operations
- R&D, marketing, SG&A and other functions are local activities
- Local entities responsible for Group P&L (predictable, fixed margin at HQ level)



1.3.3.13 Ultimately, however, most multinationals are, to a greater or lesser degree, integrated, i.e. centralized. Under an integrated model, the headquarters may be responsible for setting out the strategy, for providing detailed instructions to local entities, managing R&D, marketing, centralized back office services and other areas. Benefits of such an integrated structure may include centralizing the allocation of scarce resources, capital, and providing a single "face" to customers and investors. In such a model, local offices have less autonomous decision making authority, and fewer risks to manage.

1.3.3.14 Another approach for assessing an MNE's business model is to look at each entity's functions, assets and risks, performing this evaluation from the simpler entities to the more complex. A complex entity may own, manage and develop intangibles and make key strategic decisions. A simpler entity would normally undertake more routine tasks with lower risk such as contract manufacturing or support service provision.

1.3.3.15 In practice there are a number of typical examples, or archetypes for sales functions, manufacturing activities and support functions. Depending on the type of activities and the level of risks assumed, the range of individual entity functions and the resulting individual entity profit potential may vary. The diagram below depicts the relationship between functions, risks, assets and profit potential.

Figure 1.D.8
Example of a Centralized Business Model

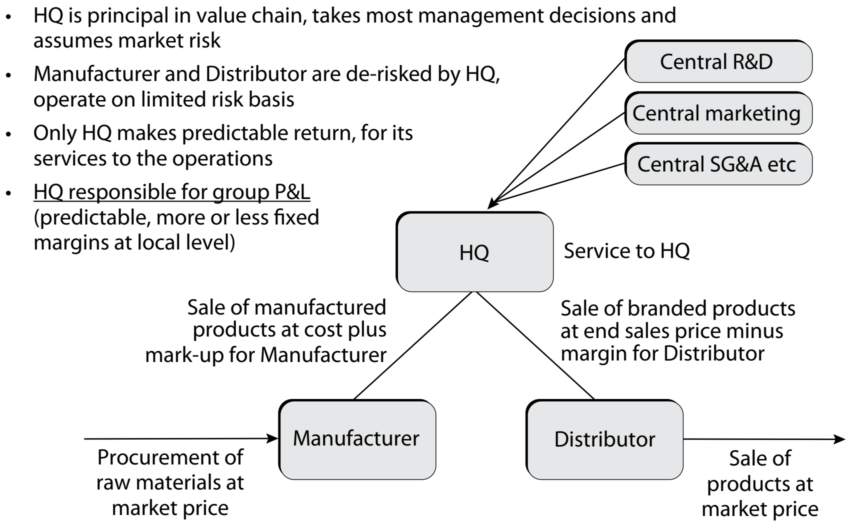
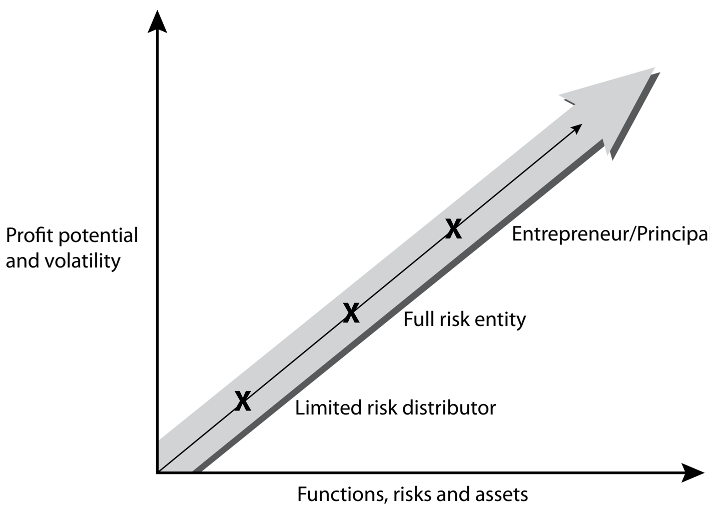
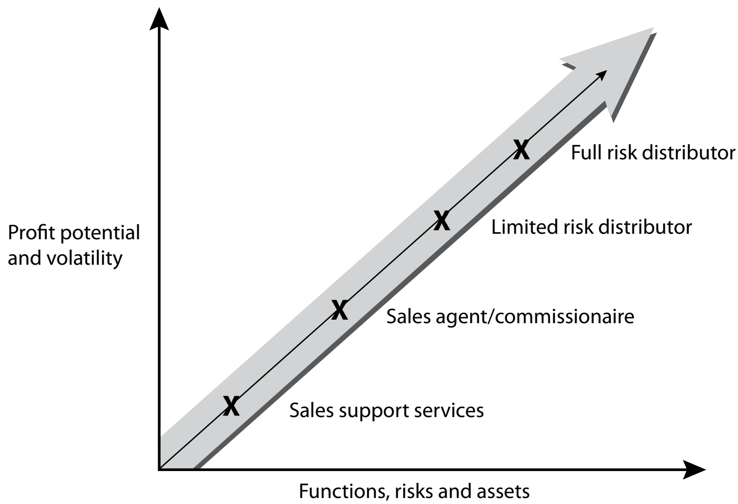


Figure 1.D.9
The Relationship Between Functions, Risks, Assets and Profit Potential



1.3.3.16 A number of archetypes can be identified within the sales function. At one end of the spectrum is the example of a sales support service and, at the other end, a full risk distributor. In between these examples different models are possible such as: sales agent/commissionaire, limited risk distributor, or licensed distributor (moving along the value chain from low to high). A full risk distributor generally takes price and other market risks, stock risks, credit risks and may in addition develop and license a trade name or other intangible.

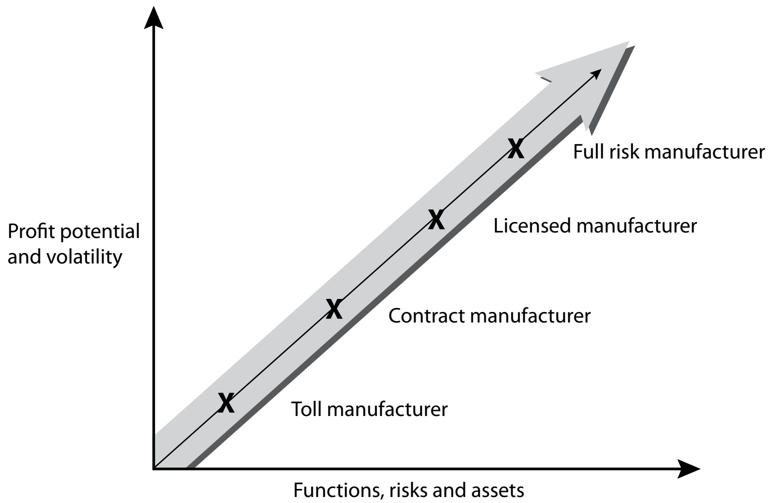
Figure 1.D.10
Different Types of Distribution Operations



1.3.3.17 Different types of manufacturing operations can be identified in the manufacturing function. Terms commonly used to identify the spectrum of archetypes, increasing in terms of manufacturing function and the potential for profit, range from toll manufacturer to contract manufacturer, licensed manufacturer and ultimately the full risk manufacturer. The lowest risk entity is likely to be a toll manufacturer, although a toll manufacturer, as with the other types of manufacturers, will likely retain the risk of fixed asset investment and risks associated with sub-optimal utilization of manufacturing capacity. In general, the entrepreneur retains title to both raw materials and goods throughout the whole manufacturing process. The entrepreneur buys the raw materials and bears inventory and sales risk, while the toll manufacturer is primarily responsible for the management and effective utilization of the manufacturing site.

1.3.3.18 The following two examples draw upon the discussion above to provide illustrations of how MNEs in specific industries might choose to organize their operations.

Figure 1.D.11
Different Types of Manufacturing Operations



Example 1: Fast-moving Consumer Goods

1.3.3.19 Fast-moving consumer goods (FMCG) are products that sell quickly at relatively low cost—items such as confectionery, dairy products, other foodstuffs and home and personal care products. Nearly everyone in the developed and developing world uses some form of FMCGs every day. They are the small-scale consumer purchases which are made at the kiosk, produce stand, grocery store, supermarket or warehouse outlet. FMCGs have short shelf lives, so, while the profit margin on individual FMCG sales may be low, the volume of sales is expected to make up for it.

1.3.3.20 To become successful in the highly dynamic and innovative FMCG segment, a company has to be acquainted with the consumer, brands, and logistics, but also, it has to have a sound understanding of packaging and product promotion.[14] Understanding consumer needs, and responding to them quickly is a key element to success in the FMCG segment. FMCG companies have to gain and maintain a deep understanding of consumers' needs, lifestyles and spending patterns in the market targeted. The FMCG company must adapt to the evolution of consumers' shopping habits and tastes in order to effectively place its products in the market.

[14] Shaout, A., & Yousif, M. K. (2014). Employee Performance Appraisal System Using Fuzzy Logic. *International Journal of Computer Science & Information Technology, 6(4), 1 - 19.*

1.3.3.21 Branding is a key element of success for FMCG companies. FMCG companies rely on marketing, communications and other techniques to establish and develop brand awareness and loyalty to their products. While superior and innovative physical packaging notably attracts the consumer and helps to convey the message of the brand in the stores, communications through different media and interactions with the consumers are also important to create awareness outside retail outlets and ultimately induce customers to make repeat purchases.

1.3.3.22 Controlling input and manufacturing costs is vitally important in this business. This requires efficient product sourcing, input logistics strategies and innovative technology.

1.3.3.23 Another key factor in the FMCG sector is to have efficient, predictable and trustworthy distribution channels. While some retailers opt for vertical integration (this is particularly relevant for developing countries, where distribution channels may not always be as structured as in developed countries) others outsource logistics and warehousing services to trusted third parties. Indeed, in some countries, quality logistics and warehousing services with local knowledge and expertise are increasingly available for businesses at relatively lower cost, enabling even small and medium-sized enterprises to obtain these capabilities early in their business cycle.

1.3.3.24 There are several ways an FMCG company can distribute its products to reach end-consumers, depending on the company's level of vertical integration and the number of intermediaries:

- first, the simplest distribution channel is a direct sale from manufacturers to consumers with no intermediary, often through an online store;
- second, there are distribution channels where there can be one intermediary as the middleman between the producer and consumer. An example is a brick-and-mortar retailer between manufacturer and consumer. This retailer can be independent or be part of the same group as the producer;
- third, the distribution channel can involve two intermediaries between producer and consumer. An example is a wholesaler selling to a retailer which then sells to the consumer; and
- finally, there are distribution channels where an agent or broker is used. Agents work on behalf of companies and deal primarily with wholesalers. From here, the wholesalers sell to retailers which then sell to consumers.

1.3.3.25 These different types of distribution channels are summarized in the following chart:

Figure 1.D.12
Different Types of Distribution Channels

Example 2: Oil and Gas Industry

1.3.3.26 International Oil Companies (IOCs) are investor-owned, market-oriented, and mainly aim to increase shareholder value. Various degrees of size, specialization and integration exist in IOCs. Often, companies specialize in one or more individual industry segments, such as the exploration and production, refining, transportation/distribution or marketing segments. Many of the largest multinational oil and gas companies integrate all businesses and are referred to as "vertically integrated" oil companies.[15]

1.3.3.27 An example of a vertical integrated oil and gas company can be depicted as per Figure 1.D.13 below:

1.3.3.28 The oil and gas industry is often considered to have two major parts: "Upstream" activities — those related to the exploration and production of crude oil and natural gas, and "Downstream" activities — those related to the transportation, refining and marketing of oil and natural gas and their products.[16]

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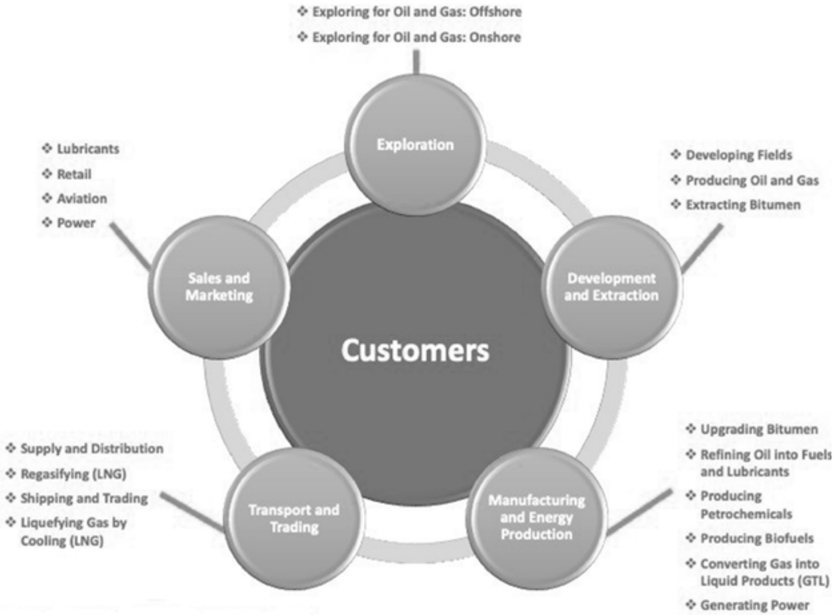
15 UN (2017). *Handbook on Selected Issues for the Taxation of the Extractive Industries by Developing Countries*. New York: UN Publishing. Available from https://www.un.org/esa/ffd/wp-content/uploads/2018/05/Extractives-Handbook_2017.pdf.

16 Sometimes the term "midstream" is also used — for example: "[a]ctivities

Figure 1.D.13
Example of a Vertically Integrated Oil and Gas Company



Source: International Tax and Investment Center (ITIC)

1.3.3.29 Within the two major business parts, there are often several different organizational units representing different business lines. In Upstream, a distinction may be made for example between “exploration” activities and “production” activities, while in Downstream there may be a trading, manufacturing or chemicals businesses. In a vertically integrated IOC, the company may have multiple global businesses with different business models and multiple cost centres.

1.3.3.30 Each different business line can have a different business model. Certain activities can be centralized, for example service companies which provide advice and services to operating companies, i.e. technical advice or accounting services. The cost of those centralized services may be cost-shared or directly charged to an operating company. The production of oil may be completely decentralized.

connecting the pure upstream and downstream functions are sometimes referred to as “midstream,” and consist of trading and transportation (by pipeline, rail, barge, tanker or truck) storage, and wholesale marketing of crude oil, natural gas or refined petroleum products”—UN (2017). *Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries.* New York: UN Publishing.

1.3.3.31 The management of each production facility is typically responsible for the performance and long-term viability of its own operations but can draw on the experience of service companies and, through them, of other group companies. Intangibles can be owned centrally, whereas R&D centres around the globe might be doing research. Depending on the products and the manufacturing sites, different models may be used, including contract manufacturing and toll-manufacturing models. And finally, once products are sold to the market, all typical sales functions can be identified: buy-sell distributors, licensed distributors, direct sales, in-market service companies, etc.

1.4 Managing the Transfer Pricing Function in a Multinational Enterprise

1.4.1 MNEs face challenges in managing their transfer pricing function. While transfer pricing may be used in some MNEs for management control, MNEs nevertheless are required to comply with the transfer pricing rules for tax purposes in the countries in which they operate. The determination of the transfer price affects the allocation of taxable income between the associated enterprises of an MNE.

1.4.2 Entities in an MNE conduct a global business that gives rise to opportunities to optimize the value chain of goods or services and they therefore look for synergies. A challenge facing an MNE conducting a global business with associated enterprises is whether the transfer pricing method used for internal transactions is acceptable to the tax authorities in the countries in which the MNE operates. The transfer pricing challenge becomes even greater when the MNE has multiple global businesses with different business models and multiple cost centres. The size of the MNE adds to the complexity.

1.4.3 Financial reporting for MNEs is informed by two decision trees. On the one hand, corporate and tax law require an associated enterprise to determine its taxable income derived from a specific jurisdiction. On the other hand, an MNE will usually need to determine for management purposes the income and costs of its business lines, which, as the previous discussion shows, can operate across several jurisdictions. In other words, while tax authorities focus on an associated enterprise's taxable income, an MNE's managers focus on income from their business lines. MNEs should develop and publicize within the enterprise a global transfer pricing policy to help minimize the risk of transfer pricing adjustments which may result in double taxation.

1.4.4 The allocation of profits and costs to the various legal structures is based on the functions performed, assets employed and risks assumed (so-called "FAR analysis"). Since MNE groups consist of numerous associated enterprises it is very difficult to allocate the profits and costs to all the separate legal entities, especially due to the absence of market forces. It is a complex exercise to come up with a consistent and coherent global policy for allocating results to the legal structures.

1.4.5 Transfer pricing rules based on the arm's length principle allow national tax authorities to make adjustments to the profits of an enterprise where the terms of transactions between associated enterprises differ from terms that would be agreed between unrelated enterprises in similar circumstances. If the income of an associated enterprise in Country A is increased as a result of a transfer pricing adjustment, it would be reasonable to expect a corresponding transfer pricing adjustment to reduce the income of the other associated enterprise in Country B provided a consistent transfer pricing evaluation is made by both countries.

1.4.6 However, if the tax authority of Country A makes a transfer pricing adjustment, double taxation will occur if the tax authority of Country B does not agree with the adjustment and does not allow a corresponding (downwards) adjustment. The risk is of "economic" double taxation, i.e. where two different legal entities are taxed on the same profits. It is the task of the transfer pricing function within an MNE to limit the risk of transfer pricing adjustments and double taxation.

1.4.7 In principle, for an MNE, designing, implementing and documenting an appropriate transfer pricing policy should not be viewed solely as a compliance issue. The main goal should be to develop a consistent and principles-based global policy. A well-developed and consistently applied transfer pricing policy should reduce an MNE's risk of transfer pricing adjustments and the potential for double taxation, thereby increasing profitability by minimizing transfer pricing costs. Moreover, a global transfer pricing policy may be used as evidence in negotiations with tax authorities when transfer pricing disputes occur.

1.4.8 A comprehensive transfer pricing policy should cover four key areas.

- Advisory;
- Reporting;
- Documentation; and
- Audit support/dispute resolution.

1.4.9 Advising on transfer pricing matters requires a thorough knowledge of an MNE's business operations. There may be a misconception that the tax department makes the key business decisions within an MNE. In practice, the business units of an MNE will identify business opportunities and a decision may be taken to exploit the opportunity if it fits within the MNE's global business strategy. Advice can be provided to minimize the risk of transfer pricing adjustments and therefore optimize the business opportunity if the tax department is involved in an MNE's decision-making.

1.4.10 There is an increasing level of detail required to meet each country's transfer pricing documentation requirements in the current global environment. Most MNEs therefore prepare global and regional documentation (master files) for their various global businesses. Global and regional reports are prepared for local purposes (local files) based on the identified tax risks for each country in which the MNE operates.

1.4.11 Tax authorities around the world are increasingly focused on transfer pricing and on expanding their transfer pricing capabilities. MNEs have to deal with the detailed, complex and potentially conflicting domestic transfer pricing legislation in the countries in which they operate. Some countries closely follow guidance from international bodies, others only implement part of the guidance while some develop transfer pricing rules independently.

1.4.12 It should not be generally assumed that MNEs are not complying with transfer pricing rules in order to obtain tax benefits. Corporate management is under pressure to control corporate costs including tax costs; however many MNEs, especially those with shares quoted on a stock exchange (listed MNEs), may have published codes of conduct, a set of business principles, or both. Some of these codes or principles may explicitly require that an MNE must comply with the tax rules of the countries in which they operate. Violations of these codes may result in severe consequences for a listed MNE. Nevertheless, they should not be seen as a guarantee that there may not be a disagreement about the proper application of the transfer pricing rules.

1.4.13 As transfer pricing is often referred to as "an art, not a science", the resulting uncertainty creates the potential for transfer pricing disputes, even if the MNE is seeking to comply with domestic transfer pricing rules. MNEs may invest in setting appropriate transfer prices and preparing comprehensive documentation, but the risk that tax authorities disagree with the approach taken may remain. This creates uncertainty for MNEs and may result in costs associated with preparing additional documentation, managing tax audits and conducting litigation. Notwithstanding this, there are cases where transfer prices are manipulated to shift profits from one jurisdiction to another to gain tax benefits including low taxation or no taxation.

1.4.14 MNEs generally express a preference for transfer pricing rules if they are able to achieve a globally consistent approach and eliminate the risk of disputes. If an MNE's transfer prices are adjusted in one country, resulting in higher taxable income, the associated enterprise in the other country should in principle[17] receive a "corresponding adjustment", reducing its taxable income. Where, there is no corresponding adjustment in the absence of a treaty or by express agreement through the treaty provisions, the MNE will suffer double taxation. In this situation, the dispute is between two tax authorities with the MNE seeking to have consistent transfer prices accepted by both countries.

1.4.15 Where a transfer pricing adjustment is made by the tax authority, Article 9 of the UN Model Tax Convention or the equivalent article in a bilateral tax treaty (where applicable) provides for a corresponding adjustment to be made in the other jurisdiction. However, in some cases there may be legitimate reasons why a corresponding adjustment is not given, or is less than the original adjustment. In such a case, it is appropriate for the two countries to enter into discussions under the mutual agreement procedure mechanism provided for in Article 25 of the UN Model (or a corresponding provision in an actual treaty) to try to resolve any double taxation which arises.

[17] UN and OECD Model Tax Conventions, Article 9 (Associated Enterprises).

Part B

DESIGN PRINCIPLES AND POLICY CONSIDERATIONS

2 Introduction to Transfer Pricing

2.1 What is Transfer Pricing?

2.1.1 General

2.1.1.1 This chapter gives a brief outline of the subject of transfer pricing and identifies several of the practical issues and concerns surrounding it, especially the issues faced, and approaches taken by developing countries. These are addressed in greater detail in later chapters.

2.1.1.2 A significant volume of global trade consists of international transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within an MNE; such transfers are called "intragroup transactions". There is evidence that intragroup trade has been growing steadily since the mid-20th century.

2.1.1.3 In addition, transactions involving intangibles and multi-tiered services constitute a rapidly growing proportion of an MNE's commercial transactions and have greatly increased the complexities involved in analyzing and understanding such transactions.

2.1.1.4 The structure of transactions within an MNE[18] is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. A large and growing number of intragroup transactions may therefore not be governed entirely by market forces but will largely be driven by the common interests of the entities of a group. Since tax calculations are generally based on entity-level accounts, the prices or other conditions at which these intragroup transactions take place will affect the relevant entities' income and/or expenses in relation to those transactions, and as a consequence, will impact on the amount of profit each group entity records for tax purposes.

[18] For transfer pricing purposes, the component parts of an MNE, such as companies, are called "associated enterprises".

2.1.1.5 It therefore becomes important to establish the appropriate price, called the "transfer price", for intragroup transfers. "Transfer pricing" is the general term for the pricing of transactions between related parties. Transfer pricing refers to the setting of prices[19]for transactions between associated enterprises (*i.e.* members of the same MNE) involving the transfer of property or services. These transactions are also referred to as "controlled" transactions, as distinct from "uncontrolled" transactions between persons that are not associated with each other and can be assumed to operate independently ("on an arm's length basis") in setting terms and conditions for such transactions.

2.1.1.6 Transfer pricing does not necessarily involve tax avoidance, as the need to set such prices is a normal aspect of how MNEs must operate. Where the pricing does not accord with internationally applicable norms or with the arm's length principle under domestic law, the tax administration may consider this to be "mis-pricing", "incorrect pricing", "unjustified pricing" or non-arm's length pricing, and issues of tax avoidance and evasion may potentially arise.

2.1.2 Examples

2.1.2.1 **Example 1: Solid State Drive Manufacturer**

The X Group is in the business of selling computers. The group as a whole is profit making. The parent company, located in Country A, buys "solid state drives" from its subsidiary in Country B. The price the parent company in Country A pays its subsidiary company in Country B (the "transfer price") will determine how much profit the subsidiary reports in Country B and how much local income tax it pays. If the parent company pays the subsidiary a price that is lower than the appropriate arm's length price, the subsidiary may appear to be in financial difficulty, even if the group as a whole shows a reasonable profit margin when the completed computer is sold.

Country A's tax authorities might agree with the profit reported at their end by the parent company, but their Country B counterparts may not agree—they may not have the expected profit to tax on their side of the

[19] However, in most cases the transfer pricing analysis will end after an appropriate profit margin has been determined. See Chapter 4 of this Manual for a discussion on Transfer Pricing Methods.

operation. If the parent company in Country A had purchased its drives from an independent company in Country B under comparable circumstances, it would pay the market price, and the supplier would pay taxes on its own profits in the normal way. From this analysis, and assuming that Country A's income tax rate is lower than Country B's, the fact that higher profits will be reported in Country A may result in the presumption that the transfer price was fixed at below the arm's length amount in order to minimize the group's income tax incidence.

Accordingly, when the various parts of the organization are under some form of common control, it may mean that transfer prices are not subject to the full play of market forces and the correct arm's length price, or at least an "arm's length range" of prices, needs to be arrived at.

2.1.2.2 **Example 2: Luxury Watch Manufacturer**

A luxury watch manufacturer (Group Y) in Country A distributes its watches through a subsidiary in Country B. It is assumed that the watch costs $1400 to make and it costs the Country B subsidiary $100 to distribute it. The company in Country A sets a transfer price of $1500 and the subsidiary in Country B retails the watch at $1600 in Country B. Overall, the company has thus made $100 in profit, on which it is expected to pay tax.

However, when the subsidiary is audited by Country B's tax authorities, they notice that the distributor itself does not earn any profit: the $1500 transfer price plus the distributor's $100 distribution costs are exactly equal to the $1600 retail price. Country B's tax authorities consider that the transfer price should be set at $1400 so that the distributor can make a profit (in this case $100) that would be subject to tax in Country B.

This poses a problem for MNE Y, as it is already paying tax in Country A on the $100 profit per watch shown in its accounts. Thus, while MNE Y has earned a total profit of only $100, it is paying tax on a total of $200, $100 in Country A and $100 in Country B.

As a result, the MNE can end up paying income tax twice on the same profits. The difference of opinion between Country A and Country B about what constitutes the appropriate transfer price for the watch can lead to economic double taxation.

2.1.3 Summary of Transfer Pricing Concept

2.1.3.1 Transfer prices may also affect the measurement of the performance of individual entities in an MNE. The individual entities within a multinational group may be separate profit centres and transfer prices are required to determine the profitability of the entities. However, not every entity would necessarily make a profit or loss under arm's length conditions. Rationally, an entity having a view to its own interests as a distinct legal entity would only acquire products or services from an associated entity if the purchase price was equal to, or cheaper than, prices being charged by unrelated suppliers. This principle applies, conversely, in relation to an entity providing a product or service; it would rationally only sell products or services to an associated entity if the sale price was equal to, or higher than, prices paid by unrelated purchasers. On this basis prices should gravitate towards the "arm's length price", i.e. the price that would be agreed upon between unrelated parties in similar circumstances.

2.1.3.2 While the foregoing explanation of transfer pricing sounds logical and simple enough, arriving at an appropriate transfer price may be a complex task, particularly because of the difficulties encountered in respect of certain transactions, e.g., in identifying and valuing intangibles transferred and/or services provided. For example, intangibles could be of different types such as industrial assets like patents, trade names, designs or models, literary and artistic property rights, know-how or trade secrets, which may or may not be reflected in the accounts of the company. There are thus many complexities involved in dealing with transfer pricing in cross-border transactions between MNE entities.

2.2 Basic Issues Underlying Transfer Pricing

2.2.1 Transfer prices serve to determine the income of the entities or parties involved in the cross-border transaction. A higher price increases the seller's income and decreases the buyer's income. A lower price decreases the seller's income and increases the buyer's income. The transfer price therefore influences the tax base of both the country of the seller and the country of the buyer involved in a cross-border transaction.

2.2.2 From a taxation perspective, in any cross-border scenario, the parties involved are the relevant entities of the MNE along with the tax authorities of the countries involved in the transaction. When one country's tax authority adjusts the profit of a member firm of the MNE by adjusting the transfer price of a controlled transaction, this may have an effect on the tax base of another country; see 1.4.14 and 1.4.15 for a summary of the issues that may arise. Accordingly, cross-border situations involve issues related to jurisdiction, allocation of income, and valuation.

2.2.3 The key issues are: (i) which government should tax the income of the group entities engaged in the transaction, and (ii) what happens if both governments claim the right to tax the same income? If economic activities in more than one country contribute to the MNE's profits, should one of the governments give tax relief to prevent double taxation of the MNE's income, and if so, which government should give such relief?

2.2.4 An added issue relates to the motivation for transfer pricing manipulation. MNEs may engage in practices that seek to reduce their overall tax bills. This may involve profit shifting through non-arm's length transfer pricing in order to reduce the aggregate tax burden of the MNE. However, while reduction of taxes may be a motive influencing the MNE in setting transfer prices for intragroup transactions, it is not the only factor that determines transfer pricing policies and practices; see 1.4.1. et seq. for a detailed discussion.

2.2.5 The aim of non-arm's length transfer pricing in such cases may be to reduce an MNE's worldwide taxes. This can be achieved by shifting profits from associated entities in higher tax countries to associated entities in relatively lower tax countries through either undercharging or overcharging the associated entity for products or services. For example, if the parent company in an MNE has a tax rate in its residence country of 30 per cent, and if a subsidiary of that parent company is resident in another country which has a tax rate of 20 per cent, the parent may have an incentive to shift profits to its subsidiary to reduce its tax rate on these amounts from 30 per cent to 20 per cent. This may be achieved by the parent being overcharged for the acquisition of property and services from its subsidiary.

2.2.6 While the most obvious motivation may be to reduce the MNE's global effective tax rate, other factors may influence transfer pricing decisions, such as the imputation of tax benefits in the parent company's country of residence. See further 1.4.1. et seq.

2.2.7 A further motivation for an MNE to engage in such practices is to use a tax benefit, such as a tax loss, in a jurisdiction in which it operates. This may be either a current year loss or a loss that has been carried forward from a prior year by an associated company. In some cases, a group company may wish to take advantage of an associated company's tax losses before they expire, in situations where losses can only be carried forward for a certain number of years. Even if there are no restrictions on carrying forward tax losses by an associated company, the group company has an incentive to use the losses as quickly as possible. In other words, profits may sometimes be shifted to certain countries in order to obtain specific tax benefits.

2.2.8 MNEs operate on a global basis and entities comprising the MNE may share common resources and overhead expenses. From the perspective of the MNE these resources need to be allocated with maximum efficiency in an optimal manner.

2.2.9 From the government's perspective, the allocation of costs and income from the MNE's resources is an essential element in calculating the tax payable. There can thus be a dispute between countries in the allocation of costs and resources, owing to each of the countries having the objective of securing the tax base in its jurisdiction. Where none of the relevant countries permit a tax deduction for legitimate business expenses incurred by the MNE, double taxation can result.

2.2.10 From the MNE's perspective, any trade or taxation barriers in the countries in which it operates raise the MNE's transaction costs while distorting the allocation of resources. Furthermore, many of the common resources which are a source of competitive advantage to an MNE cannot be separated from the income of the MNE's members for tax purposes. This is especially true in the case of intangibles and service-related intragroup transactions.

2.2.11 Mere allocation of income and expenses to one or more members of the MNE is not sufficient; the income and expenses must also be *valued*. A key issue of transfer pricing is therefore the valuation of intragroup transfers.

2.2.12 As MNEs are integrated structures with the ability to exploit international differentials and to utilize economies of integration not available to stand-alone entities, transfer prices within the group may not always be the prices that unrelated parties negotiate for similar transactions. See 2.5.5 for a discussion of MNE Group synergies.

2.2.13 International tax issues, especially transfer pricing related issues, throw open a number of challenges, the complexity and magnitude of which are often especially daunting for tax administrations with limited capacity or experience to deal with such issues.

2.2.14 One such complex yet pressing issue, especially given the exponential rise of the digital economy, is arriving at the appropriate arm's length price for transactions involving intangibles. Intangibles are often unique, mobile and difficult to value and this presents unique problems for taxpayers and tax authorities alike.

2.2.15 Transfer pricing issues related to business restructuring and intra-group services also present special challenges. Transfer pricing documentation requirements for MNEs continue to be a key focus area given the evolution of stringent documentation standards, including CbC reporting, not to mention the increasing information exchange between governments on international transactions. These basic and critical transfer pricing issues are addressed in detail in this Manual in separate chapters.

2.2.16 Overall, it should be clear that transfer pricing rules are essential for countries in order to protect their tax base, to eliminate double taxation and to enhance cross-border trade. For developing countries, transfer pricing rules are essential to provide a climate of certainty and an environment for increased cross-border trade while at the same time ensuring that the country is not losing out on critical tax revenue. Transfer pricing is thus of paramount importance and detailed transfer pricing rules are essential.

2.3 Evolution of Transfer Pricing

2.3.1 This section aims to briefly trace the history and the reasons for transfer pricing taxation regimes. It is important to note that transfer pricing essentially involves the application of economic principles to a fluid marketplace. Thus, new approaches and techniques that help arrive at the appropriate transfer price from the perspective of one or more factors in the system continue to be developed.

2.3.2 Transfer pricing rules are based on and implement the provisions of the Associated Enterprises Article (generally Article 9) of most bilateral tax treaties. The basic provisions of Article 9, and the arm's length principle on which that Article is based, were developed by the League of Nations in the 1920s and have been a feature of the international tax system ever since.

2.3.3 The OECD Transfer Pricing Guidelines, as amended and updated, were first published in 1995 to provide an authoritative and internationally agreed interpretation of the OECD Model Treaty and the largely identical provisions of the UN Double Tax Convention, both of which are based on the earlier League of Nations agreements. The 1995 publication of the OECD Transfer Pricing Guidelines followed previous OECD reports on transfer pricing in 1979 and 1984. The OECD Transfer Pricing Guidelines represent a consensus among OECD Members (mostly developed countries) and have largely been followed in domestic transfer pricing regulations of these countries. Another influential interpretation of the arm's length principle which has evolved over time is represented by the USA Transfer Pricing Regulations (26 USC section 1.482).

2.3.4 From a financial perspective, transfer pricing is probably the most important cross-border tax issue globally. This is partly because the term "MNE" not only covers large corporate groups but also smaller groups with one or more subsidiaries or permanent establishments (PEs) in countries other than those where the parent company or head office is located.

2.3.5 The ongoing and continuous relocation of the production of components and finished products to particular countries; the rise of many new economies in the developing countries with their infrastructure, skilled labour, low production costs, conducive economic climate etc.; the round-the-clock trading in financial instruments and commodities; and the rise of e-commerce and Internet-based business models are a few of the many reasons why transfer pricing has become such a high profile issue over the past couple of decades.

2.3.6 Other considerations have also had an impact on the importance of transfer pricing. Some developed countries have tightened their transfer pricing legislation to address the issue of foreign enterprises active in their countries paying lower tax than comparable domestic groups. Some developing countries have introduced equally exhaustive transfer pricing regulations in their countries to keep their tax bases intact. Other developing countries are recognizing that they need to effectively address the challenges of transfer pricing in some way.

2.3.7 Countries with less sophisticated tax systems and administrations run the risk of absorbing the effect of stronger enforcement of transfer pricing in developed countries. This in effect results in such countries paying at least some of the MNEs' tax costs in their countries; to avoid this, many countries have introduced transfer pricing rules.

2.3.8 The G20/OECD Base Erosion and Profit Shifting (BEPS) Project resulted in the release, in 2015, of final reports on measures based on 15 Actions. Among other things, the BEPS reports contain extensive revisions of the OECD Transfer Pricing Guidelines, provide model provisions to prevent treaty abuse, call for standardized country-by-country reporting in documentation requirements, elucidate a peer review process for addressing harmful tax practices and endorse a minimum standard to secure progress on dispute resolution. They also made other detailed recommendations.[20]

2.3.9 While the OECD BEPS initiative, theoretically, is aimed at revamping international tax standards to keep pace with the changing global business

[20] https://www.oecd.org/ctp/beps-2015-final-reports.htm

environment, the practical implementation of such measures is dependent on the individual countries making necessary changes to their domestic laws as well as modifying treaty provisions with other countries and doing all of this in a coordinated manner. Towards accomplishing this objective, the OECD/G20 Inclusive Framework on BEPS, with a membership including about 70% of non-OECD and non-G20 countries from all geographic regions, was set up in 2016. The members of the Inclusive Framework are collaborating on the implementation of the 15 measures to tackle tax avoidance, improve the coherence of international tax rules, and ensure a more transparent tax environment.[21]

2.4 The Arm's Length Principle in Transfer Pricing

2.4.1 Legal Basis of the Arm's Length Principle

2.4.1.1 The UN Model Tax Convention Article 9(1) states the following:

> "Where:
>
> (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of these conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly".[22]

2.4.1.2 In other words, the transactions between two related parties should reflect the outcome that would have been achieved if the parties were not related i.e. if the parties were independent of each other and the outcome (price or margins) was determined by (open) market forces. This is the basis of the "arm's length principle". The principle set out above in the UN Model has also been reiterated in the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines as supplemented and amended.

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[21] See https://www.oecd.org/tax/beps/about/

[22] UN (2017). United Nations Model Double Taxation Convention between Developed and Developing Countries. New York: UN Publications. Available from https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf

2.4.1.3 The arm's length principle is thus the generally accepted guiding principle in establishing an appropriate transfer price under Article 9 of the UN Model. The arm's length principle by itself is not new; it has its origins in contract law to arrange an equitable agreement that will stand up to legal scrutiny, even though the parties involved may have shared interests.

2.4.1.4 Under the arm's length principle, transactions within a group are compared to transactions between unrelated entities under comparable circumstances to determine acceptable transfer prices. Thus, the marketplace comprising independent entities is the measure or benchmark for verifying the transfer prices for intragroup transactions and their acceptability for tax purposes.

2.4.1.5 The rationale for the arm's length principle itself is that because the market governs most of the transactions in an economy it is appropriate to treat intragroup transactions as equivalent to those between independent entities. Under the arm's length principle, intragroup transactions are tested and may be adjusted if the transfer prices or other terms of the transactions are found to deviate from those of comparable uncontrolled transactions. The arm's length principle is argued to be acceptable to everyone concerned as it uses the marketplace as the norm.

2.4.1.6 Article 9(2) of the UN Model also requires that when the tax authorities of a Contracting State make a transfer pricing adjustment to reflect the application of the arm's length principle to the taxpayer's related party transactions, the other Contracting State should make an appropriate "corresponding adjustment" in order to avoid double taxation. The competent authorities[23] of the Contracting States are to consult with each other, if necessary, in determining an agreed adjustment.

2.4.1.7 The UN Model contains provisions (Article 9(3)) which stipulate that a Contracting State is not required to make the corresponding adjustment referred to in Article 9(2) where judicial, administrative or other legal proceedings have resulted in a final ruling that, by the actions giving rise to an adjustment of profits under Article 9(1), one of the enterprises concerned is liable to a penalty with respect to fraud, or to gross or wilful default.

2.4.1.8 An argument in favour of using the arm's length principle is that it is geographically neutral, as it treats profits from investments in different places in a similar manner. However, this claim of neutrality is conditional on consistent rules and administration of the arm's length principle throughout

[23] Officials designated by countries to discuss treaty and other international tax-related issues with each other.

the jurisdictions in which an international enterprise operates. In the absence of consistent rules and administration, international enterprises may have an incentive to avoid taxation through transfer pricing manipulation.

2.4.2 Application of the Arm's Length Principle

2.4.2.1 While it is relatively easy to describe the arm's length principle, establishing guidelines on the practical application of the principle is a complex task. Practical application of the arm's length principle requires identification of reliable comparable transactions.

2.4.2.2 The example below illustrates a situation where the arm's length principle needs to be applied:

Example: Automobile Seat Manufacturer

Assume a Corporation P (parent) manufactures automobile seats in Country A, then sells the finished seats to its Subsidiary S in Country B which in turn sells those finished seats to unrelated parties (e.g. the public at large) in Country B. In such a case S's taxable profits are determined by the sale price of the seats to the unrelated parties minus the price at which the seats were obtained from its parent corporation (cost of goods sold in the accounts of S, in this case the transfer price) and its expenses other than the cost of goods sold.

If Country A where the seats are manufactured has a tax rate much lower than the tax rate in Country B where the seats are sold to unrelated parties, then perhaps the group would have an incentive to book as much profit as possible in the hands of Corporation P in Country A by overvaluing the sale price of the seats (the transfer price) to its Subsidiary S in Country B. If the tax rate was higher in Country A than in Country B, then perhaps the group would have an incentive to under-price the seats to Subsidiary S in Country B and thus concentrate the profits in Country B.

Based on these facts, it is seen that when associated enterprises deal with each other their commercial or financial relations may not be directly affected by market forces but may be influenced more by other considerations (see the caution at 2.4.2.3). The arm's length principle therefore seeks to determine whether the transactions between related taxpayers (in this case Corporation P and its Subsidiary S) are appropriately priced to reflect their true tax liability by comparing them to similar transactions that take place at arm's length between unrelated taxpayers.

2.4.2.3 Intangibles can present a unique challenge when applying the arm's length principle due to the fact that intangibles may be difficult to identify, value and find comparables for.

2.4.2.4 In practice, various factors can affect the arm's length price. These factors range from government policies and regulations to cash flows of the entities in the MNE.

2.4.2.5 There should not be an implicit assumption on the part of the tax authorities that there is profit manipulation by the MNE simply because there is an adjustment to approximate the arm's length transaction; any such adjustment may arise irrespective of the contractual terms between the entities. Another incorrect assumption, sometimes made in practice, is that the commercial or financial relations between associated enterprises and in the marketplace will always be different and at odds with each other.

2.4.2.6 In many cases the MNEs themselves may have an incentive to set an arm's length price for their intragroup transactions so as to judge the true performance of their underlying entities.

2.4.2.7 The arm's length principle has been widely accepted and is implemented into most transfer pricing legislation across the world. Overall, the underlying idea behind the arm's length principle is the attempt to place transactions, both uncontrolled and controlled, on equal terms with respect to the tax advantages (or disadvantages) that they create. This is done by comparing the prices and other conditions of a related party transaction with the prices and other conditions of comparable uncontrolled transactions between unrelated parties.

2.4.2.8 The practical application of the arm's length principle typically involves the following processes or steps, and considerations, among others:

- Comparability analysis;
- Evaluation of transactions;
- Evaluation of separate and combined transactions;
- Use of an arm's length range or a central point in the range;
- Use of multiple year data;
- Losses;
- Location savings and location rents;
- Intentional set-offs; and
- Use of customs valuation.

2.4.2.9 The detailed processes for making these comparisons are discussed in Chapter 3 of this Manual on Comparability Analysis.

2.4.2.10 The transfer pricing methods used in making the relevant comparisons are dealt with comprehensively in Chapter 4. It is, however, important to note at the outset that there is no single transfer pricing method which is generally applicable in every possible situation.

2.4.2.11 Computing an arm's length price using transfer pricing analysis is a complex task. The task requires effort and goodwill from both the taxpayer and the tax authorities in terms of documentation, groundwork, analysis and research; comparables play a critical role. This Manual seeks to assist developing countries in that task as much as possible, but it has to be recognized that the task will rarely be a simple one. The issue of lack of comparables is explored further in Chapter 3 of this Manual on Comparability Analysis.

2.4.2.12 A possible alternative to the arm's length principle might be a Global Formulary Apportionment Method, which would allocate the global profits of an MNE group among the associated enterprises on the basis of a multi-factor weighted formula (using factors such as property, payroll and sales for example, or such other factors as may be defined when adopting the formula). A formulary apportionment approach is currently used by some states of the USA, cantons of Switzerland and provinces of Canada. The EU is also considering an optional formulary approach to harmonize its corporate taxes under the Common Consolidated Corporate Tax Base (CCCTB) - or what is now the Common Corporate Tax Base (CCTB) - initiative.

2.5. Transfer Pricing as a Current and Future Issue

2.5.1 General Issues with Transfer Pricing

2.5.1.1 Several issues arise when applying the arm's length principle to the domestic realities of developing countries. The high level of integration of international enterprises, the proliferation of intragroup trading in intangibles and services and the use of sophisticated financing arrangements have increasingly made the arm's length principle difficult to apply in practice.

2.5.1.2 Increasing globalization, sophisticated communication systems and information technology allow an MNE group to control the operations of its various subsidiaries remotely. Trade between associated enterprises often involves intangibles. The nature of the world on which international tax principles are based has changed significantly. All these issues raise challenges in applying the arm's length concept to the globalized and integrated operations of international enterprises. Overall, it is clear that in the 21st century there are real challenges in applying the arm's length principle to allocate the income of highly integrated international enterprises.

2.5.1.3 It is widely accepted that transfer pricing is not an exact science and that the application of transfer pricing methods requires the application of information, skill and judgement by both taxpayers and tax authorities. In view of the skill, information and resource "gaps" in many developing countries, this can be very difficult for those countries; the task often requires the best trained officers, who may leave the tax department after acquiring specialist skills. The intention of this Manual is to play a part in reducing those gaps.

2.5.2 Transfer Pricing and Developing Countries

2.5.2.1 For all countries, but particularly for many developing countries, equipping an administration to deal fairly and effectively with transfer pricing issues presents significant challenges.

2.5.2.2 Some of the specific challenges that many developing countries face in dealing effectively with transfer pricing issues (and which will be dealt with in more detail later in this Manual) are listed below.

2.5.3 Lack of Comparables

2.5.3.1 One of the foundations of the arm's length principle is examining the pricing of comparable transactions. Proper comparability is often difficult to achieve in practice, a factor which in the view of many weakens the continued validity of the principle itself. The fact is that many of the generally accepted transfer pricing methods directly rely on comparables (see Chapters 3 and 4). It is often extremely difficult in practice, especially in some developing countries, to obtain adequate information to apply the arm's length principle for the following reasons:

- There tend to be fewer organized operators in any given sector in developing countries; thus, finding proper comparable data can be very difficult;
- The comparable information in developing countries may be incomplete and in a form which is difficult to analyze, as the resources and processes are not available. In the worst case, information about independent enterprises may simply not exist. Databases relied on in transfer pricing analysis tend to focus on developed country data that may not be relevant to developing country markets (at least without resource and

information-intensive adjustments), and in any event are usually very costly to access; and

- Transition countries whose economies have just opened up or are in the process of opening up may have "first mover" companies who have come into existence in many sectors. In such cases there would be an inevitable lack of comparables.

2.5.3.2 Given these issues, critics of the current transfer pricing methods equate finding a satisfactory comparable to finding a needle in a haystack. Overall, it is quite clear that finding appropriate comparables in developing countries for analysis is quite possibly the biggest practical problem currently faced by enterprises and tax authorities alike, but the aim of this Manual is to assist that process in a practical way. The Toolkit produced by the Platform for Collaboration on Tax, a joint initiative of the IMF, OECD, UN and World Bank Group[24] provides additional guidance on this issue. Chapter 3 of this Manual provides analysis and practical examples on Comparability Analysis.

2.5.4 Lack of Experience and Requisite Skill Sets

2.5.4.1 Transfer pricing analysis is complex and time-consuming, often requiring time and attention from some of the most skilled and valuable human resources in both MNEs and tax administrations. Transfer pricing reports often run into hundreds of pages with many legal and accounting experts employed to create them. This kind of complexity and knowledge requirement puts tremendous strain on both the tax authorities and the taxpayers, especially in developing countries where resources tend to be scarce and the appropriate training in such a specialized area is not readily available. Notwithstanding the difficulties, many developing countries have made substantial progress in creating requisite skill sets and building capacity, while also protecting their tax base.

2.5.4.2 This Manual provides, at Part C, detailed guidance on the development of capacity and the organization of transfer pricing capacity for developing countries.

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[24] PCT (2017). *A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses*. Washington: PCT. Available from https://www.tax-platform.org/sites/pct/files/publications/116573-REVISED-PUBLIC-toolkit-on-comparability-and-mineral-pricing.pdf. This toolkit sets out in greater detail a number of strategies designed to address the issue of a lack of comparables data. See also Chapter 4 of this Manual for a discussion of transfer pricing methods, some of which do not rely on the identification of comparables. This toolkit is also available in French, Spanish and Russian.

2.5.5 Treatment of MNE Group Synergies

2.5.5.1 MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies among group members which are not generally available to independent enterprises. As explained above, MNE groups are able to minimize their costs through their integration economies, which are not available to domestic firms (see 1.2.7). Such group synergies can arise, for example, as a result of streamlined management, elimination of costly duplication of effort, economies of scale, integrated systems, purchasing or borrowing power. Such group synergies are often favourable to the group as a whole and therefore may heighten the aggregate profits earned by group members compared to independent enterprises.

2.5.5.2 In other circumstances, however, integration economies of MNE groups can lead to reduced competitiveness (see 1.2.15). The MNE group may not have a competitive edge in performing functions in-house compared to outsourcing functions to specialized firms, the size and scope of corporate operations may create bureaucratic barriers not faced by smaller and more nimble enterprises, or one portion of the business may be forced to work with systems that are not the most efficient for its business because of group-wide standards established by the MNE group.

2.5.5.3 Paragraphs 5.2.6.15 to 5.2.6.21 discuss passive association and incidental benefits in the context of intragroup services. The guidance explains that an associated enterprise should not be considered to receive an intragroup service or be required to make any payment when it obtains benefits attributable solely to being part of a larger MNE group. The benefits of association with an MNE group are not a chargeable service for the members of the MNE group. The key feature of this kind of incidental benefit is that it is passive and cannot be attributed to a deliberate concerted action taken by another member of the MNE group. On the other hand, a deliberate concerted action involves one associated enterprise performing functions, using assets, or assuming risks for the benefit of one or more other associated enterprises, such that an arm's length compensation is required.

2.5.5.4 A thorough functional and comparability analysis will include the topic of whether group synergies arise. This analysis will show the nature and source of the synergistic benefit or burden, and whether the synergistic benefit or burden arises through deliberate concerted group actions. The difference between deliberate concerted action and benefits of passive association may be illustrated by the differences in the following scenarios.

2.5.5.5 In the first example, a central purchasing manager at the parent company or regional management centre performs a service by negotiating a group-wide discount with a supplier on the condition of achieving minimum group-wide purchasing levels. Group members then purchase from that supplier and obtain the discount. In this case deliberate concerted group action has occurred notwithstanding the absence of specific purchase and sale transactions among group members.

2.5.5.6 Where a supplier unilaterally offers one member of a group a favourable price in the hope of attracting business from other group members, however, no deliberate concerted group action would have occurred. The favourable price is instead a synergistic effect that may be a comparability factor relating to the economic circumstances of the group member. In the first scenario, the deliberate concerted action of negotiating a group-wide discount is a service that should be appropriately rewarded. However, the benefits of those large-scale purchasing synergies should typically be shared by the members of the group in proportion to their purchase volumes.

2.5.5.7 Another example relates to lower interest costs, as discussed further in the section on financial transactions. Company Q may benefit from credit terms from third-party lenders that are more favourable than those obtained by otherwise similar independent enterprises because it is part of MNE X. Third-party lenders may conclude that Company Q is less likely to present credit risk because the MNE is likely to support Company P and prevent default. However, the third-party lenders have obtained no explicit guarantees from MNE X. Company P thus receives a passive, incidental benefit that cannot be attributed to a deliberate concerted action of any member of the MNE X. Instead the implicit support is a synergistic effect that may be a comparability factor relating to the economic circumstances of Company Q. In contrast, if the parent company of MNE X, Company X, provides a formal guarantee to the third-party lenders as an inducement to offer enhanced terms to Company Q, then Company X would be party to a deliberate concerted action in which it performs functions, uses assets, and assumes risks for the benefit of Company Q, such that arm's length compensation is required.

2.5.5.8 The analysis of group centralized procurement activities will often require assessment of group synergies. Assume that MNE X decides to implement a policy of cost savings by centralizing procurement functions in Company P. Company P acts to aggregate purchase orders for raw materials on behalf of group members, and thereby is able to take advantage of volume discounts that arise solely because of the MNE's aggregated purchasing. The relevant associated enterprises of MNE X buy the raw materials at the price negotiated by Company P. In this scenario, Company P performs a deliberate concerted action for which an arm's length fee should be paid by the relevant associated enterprises benefitting from the procurement service. However, Company P is not entitled to retain any part of the discounts. Any volume effect on the price of raw materials is contributed by the buying power of the associated enterprises that allow Company P to aggregate their requirements for the goods. The volume benefit should accrue to the associated enterprises contributing the buying power, less the fee payable to Company P. See 5.6. for additional guidance on how to analyze centralized procurement activities, the factors that may affect compensation for those activities, and the transfer pricing methods that may be appropriate.

2.5.6 Complexity

2.5.6.1 Transfer pricing rules continue to evolve in line with the way of doing business and increased globalization. Countries around the world are implementing transfer pricing rules to deal with complex transactions and structures adopted by MNEs. Transfer pricing compliance may involve expensive databases and the associated expertise to handle the data. Transfer pricing audits need to be performed on a case-by-case basis and are often complex and costly tasks for all parties concerned.

2.5.6.2 In developing countries many taxpayers may not have the resources to prepare detailed and complex transfer pricing reports and comply with the transfer pricing regulations. Similarly, the tax authorities of many developing countries do not have sufficient resources to examine the facts and circumstances of each and every case so as to determine the acceptable transfer price, especially in cases where there is a lack of comparables. Resource limitations of both governments and taxpayers may be especially evident when disputes between taxpayers and governments arise.

2.5.6.3 In case of disputes between the revenue authorities of two countries, the currently available prescribed option is the Mutual Agreement Procedure. This process can lead to a protracted and involved dialogue, often between unequal economic powers, and may cause strains on the resources of the companies in question and the revenue authorities of the countries.

2.5.7 Impact of the Digitalization of the Economy

2.5.7.1 The Internet has completely changed the way the world works by changing how information is exchanged and business is transacted. Physical limitations, which have long defined traditional taxation concepts, no longer apply and the application of international tax concepts to increasingly digitalized transactions and business models is sometimes problematic and unclear.

2.5.7.2 From the viewpoint of many countries, it is essential for them to be able to appropriately exercise taxing rights on these transactions, such as e-commerce and digitalized business models. Whether they can do so effectively using the current international taxation models is a matter of considerable debate. Many have suggested the amendment of key existing concepts, such as permanent establishment, as well as the introduction of new concepts, such as equalization levies or digital services taxes, to include the virtual world and its workings in the ambit of international taxation. In many developing countries, the digital economy currently plays a role as a key growth driver of their economic engine and it is therefore imperative for tax authorities to tackle transfer pricing issues related to it.

2.5.7.3 This Manual will help ensure the focus is on solutions to these problems. It will help equip developing countries to address transfer pricing issues in a way that is robust and fair to all the stakeholders, while remaining true to the goals of being internationally coherent, seeking to reduce compliance costs, and to reduce unrelieved double taxation.

3 Comparability Analysis

3.1 Rationale for Comparability Analysis

3.1.1 The term "comparability analysis" is used to designate two distinct but related analytical processes:

(1) Developing an understanding of the accurately delineated transaction, which includes:

a. Identifying the economically significant characteristics and circumstances of the controlled transaction, i.e. the transaction between associated enterprises; and

b. Identifying the respective roles and responsibilities of the parties to the controlled transaction. This is generally considered as part of the functional analysis, see further section 3.4.4.

(2) Comparing the prices and other conditions of the controlled transaction (as established in step 1 immediately above) with those in uncontrolled transactions (i.e. transactiWons between independent enterprises) taking place in comparable circumstances. The latter are often referred to as "comparable uncontrolled transactions" or "comparables".

3.1.2 The concept of comparability analysis is used in the selection of the most appropriate transfer pricing method, as well as in applying the selected method to arrive at an arm's length price or financial indicator (or range of prices or financial indicators). It plays a central role in the overall application of the arm's length principle.

3.1.3 A practical difficulty in applying the arm's length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Where independent enterprises do not undertake transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises. However, the mere fact that a comparable transaction may not be found between independent parties does not of itself mean that the controlled transaction being analyzed is not at arm's length.

3.1.4 It should be kept in mind that the relative lack of comparables for a taxpayer's controlled transaction does not imply that the arm's length principle is inapplicable to that transaction. Nor does it imply anything about whether that transaction is or is not, in fact, at arm's length. In a number of instances, it will be possible to use "imperfect" comparables, e.g. comparables from another country with similar economic conditions or comparables from another industry sector. Such comparables may need to be adjusted to eliminate or reduce the differences between that transaction and the controlled transaction as discussed in 3.1.6 below, provided such adjustments can be done reliably.

3.1.5 In other instances, where no comparables are found for a controlled transaction between associated enterprises, it may become necessary to use approaches not depending directly on comparables to find an arm's length price (see 2.5.3.2). It may also be necessary to examine the economic substance of the controlled transaction to determine whether its conditions are such that it might be expected to have been agreed between independent parties in similar circumstances—in the absence of evidence of what independent parties have actually done in similar circumstances.

3.1.6 A controlled and an uncontrolled transaction are regarded as comparable if the economically relevant characteristics of the two transactions and the circumstances surrounding them are sufficiently similar to provide a reliable measure of an arm's length result. It is recognized that in reality two transactions are seldom completely alike and in this imperfect world, perfect comparables are often not available. It is therefore necessary to use a practical approach to establish the degree of comparability between controlled and uncontrolled transactions. The two transactions do not necessarily have to be identical to be comparable. Instead, none of the differences between them could materially affect the arm's length price or profit; where such material differences exist, reasonably accurate adjustments are possible to eliminate their effect. Thus, in determining a reasonable degree of comparability, adjustments may need to be made to account for certain material differences between the controlled and uncontrolled transactions. These adjustments (which are referred to as "comparability adjustments") are to be made only if the effect of the material differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results.

3.1.7 Practical guidance is needed for cases without sufficient comparables. There are two distinct problems relating to comparables for developing countries' tax authorities. The first is lack of access to existing sources of data, such as existing non-local company databases. The second is the lack of reliable local country comparables. Each of these causes problems for local tax administrations (e.g. the lack of data impedes the reliable and efficient determination of appropriate arm's length results) and also causes problems associated with double taxation and dispute avoidance (e.g. the lack of adequate data impedes a country's ability to reach agreement with taxpayers and with other tax authorities in mutual agreement negotiations).

3.1.8 The first step in undertaking a transfer pricing analysis always involves the accurate delineation of the transaction; this includes an awareness of the industry and market context in which the transaction takes place. From this, the most appropriate transfer pricing method can be selected (bearing in mind the likely existence of necessary data) and where appropriate, a tested party will be chosen. This process should determine the kind of comparables to be sought. Where comparables operating in the same jurisdiction as the tested party are available there is no need to consider whether geographic differences might have a material impact on the prices or profits under review. However, in the absence of such information, foreign comparables should not automatically be rejected as all transfer pricing cases require a solution. A pragmatic approach, making use of the best available comparables, will often be required. Adjustments may need to be considered and made where they improve the reliability of the comparison.

3.1.9 This chapter discusses a possible procedure to identify, screen, select and adjust comparables in a manner that enables the taxpayer or tax administration to make an informed choice of the most appropriate transfer pricing method and apply that method correctly to arrive at the appropriate arm's length price or profit (or range of prices or profits).

3.2 Comparability Analysis Process

3.2.1 A typical approach that can be followed while performing a comparability analysis is outlined below. The steps listed below are by no means exhaustive but rather suggest an outline based upon which a comparability analysis could be carried out. It should be noted that the process is not necessarily linear, for example, a number of the steps may need to be carried out repeatedly until a satisfactory result is achieved.

3.2.2 A summary of the comparability analysis in operation steps are set out below. The subsequent sections of this chapter deal with each of these steps in more detail.

3.2.3 The first step is understanding the economically significant characteristics of the industry, taxpayer's business and controlled transactions; see 3.3 below. This involves:

- Gathering of basic information about the taxpayer;
- Identifying and accurately delineating the controlled transaction in question; and
- Deciding whether transactions should be evaluated separately or on a combined / aggregated basis.

3.2.4 The next step is an examination of comparability factors of the controlled transaction, see 3.4:

- Characteristics of the property or service transferred;
- Contractual terms of the transaction;
- Functional analysis of the controlled transaction under examination;
- Economic circumstances of the transaction; and
- Business strategies of the parties.

3.2.5 The remaining steps in a comparability analysis (see 3.5) are:

- Selecting the tested party/parties (if applicable under the most appropriate method selected);
- Identifying potentially comparable transactions—internal and external;
- Comparability adjustments where appropriate;
- Selection of the most appropriate transfer pricing method;
- Determination of an arm's length price or profit (or an arm's length range of prices or profits); and
- Documentation of the comparability analysis and monitoring.

3.3 Analysis of Economically Significant Characteristics and Controlled Transactions

3.3.1 Gathering of Basic Information About the Taxpayer

3.3.1.1 An essential first step to enabling effective transfer pricing analysis is the collection of information about the taxpayer to understand its business operations and activities. This factfinding process should include identification of associated enterprises involved in the controlled transaction, and gathering information about relevant cross-border controlled transactions in the context of the commercial and financial relations between the relevant members of the MNE (including the functions performed, assets used or contributed (including intangibles, see Chapter 6) and risks assumed, by each party, the nature of products/services transferred, the terms and conditions of the transaction, the economic circumstances etc.).

3.3.1.2 An analysis should be performed of the circumstances specific to each taxpayer and industry. This includes, but is not limited to, an analysis of the industry, competition, economy, regulatory factors and other elements that may significantly affect the taxpayer and its environment.

3.3.1.3 Information about the taxpayer from its annual report, product brochures, news articles, research reports prepared by independent agencies, management letters and internal reports could act as a good starting point for understanding the taxpayer's circumstances. A study of these documents will provide an idea of the industry to which the enterprise belongs, the nature of its business activities (i.e. manufacturer, wholesaler, distributor etc.), its market segment, market share, market penetration strategies utilized, type of products/services dealt in, etc.

3.3.2 Identify the Accurately Delineated Transaction

3.3.2.1 The arm's length price for a transaction between two or more controlled entities must be established in relation to transactions actually undertaken. Thus, the critical first step in any comparability analysis is to accurately define those transactions by analyzing their economically relevant characteristics, as reflected not only in the contracts between the parties, but also their conduct and any other relevant facts. In this regard, the contractual terms will generally be the starting point for the analysis (as clarified or supplemented by the parties' conduct); and to the extent that the conduct or other facts are inconsistent with the written contract, the parties' conduct (rather than the terms of the written contract) should be taken as the best evidence of the transaction(s) actually undertaken.

3.3.2.2 Tax authorities should not substitute other transactions in the place of those that have actually been undertaken. They should also not disregard actually undertaken transactions other than in exceptional circumstances. Such circumstances may exist, for example, where the arrangements viewed in their totality are not commercially rational, thereby preventing the determination of an arm's length price for each party to the transaction (taking into account their own perspectives and the options realistically available to each of them). This test is substantive and looks at the nature of the arrangements entered into; a lack of independent transactions does not, of itself, indicate that the controlled transaction lacks commercial rationality.

3.3.2.3 The test for commercial rationality must be considered from each entity's own perspective, as an arrangement that is commercially rational at group level is not necessarily arm's length from the perspective of each party.

3.3.2.4 In addition, an arrangement that is expected to leave the MNE worse off as a whole on a pre-tax basis than it would be if it had not entered into the arrangement will raise questions. The question is whether it is primarily tax driven and it may need further examination as to whether it is commercially irrational thereby preventing the determination of an arm's length price for each party to the transaction.

3.3.2.5 Where a transaction that was actually undertaken is not commercially rational, any alternative transactions that are substituted for transfer pricing purposes should correspond as closely as possible to the actual facts of the case while achieving a commercially rational expected result: i.e. one which would have enabled the parties to come to a price acceptable to both at the time the arrangement was entered into.

3.3.2.6 In general, non-recognition or substitution of transactions should not be undertaken lightly as this would create significant uncertainty for taxpayers and tax administrations. Non-recognition or recharacterization of transactions may also lead to double taxation due to the divergent views taken by countries on how any substitute transactions are structured. The ability of tax authorities to disregard or substitute transactions will depend on their powers under applicable domestic law and should be considered in developing domestic transfer pricing legislation and administrative rules. See further Chapters 6 and 10.

3.3.3 Evaluation of Separate and Combined Transactions

3.3.3.1 An important aspect of transfer pricing analysis is whether this analysis has to be carried out with respect to a taxpayer's individual international controlled transactions or whether a group of international controlled transactions that have a close economic nexus and are carried out between the same parties can be analyzed together for transfer pricing purposes.

3.3.3.2 The transfer pricing analysis should ideally be made on a transaction-by-transaction basis. However, there are cases where separate transactions are so closely linked that such an approach would not lead to a reliable result.

Where transactions are so closely interrelated or continuous that application of the arm's length principle on a transaction-by-transaction basis would become unreliable or cumbersome, transactions are often aggregated for the purpose of the analysis.

3.3.3.3 An example can be the case of transactions involving the licensing of know-how to associated manufacturers together with the supply to the licensed associated manufacturers of components needed to exploit such know-how. In such a case, the transfer pricing analysis may be more reliable if it takes into account both the license and the supply of components together, compared to a consideration of each separate activity without recognizing that they are closely interrelated transactions. Similarly, it may be difficult to separately analyze pricing of sales of products and closely linked long-term service supply contracts.

3.3.3.4 Another important aspect of combined transactions involves the use of composite contracts and "package deals" among the members of an MNE group. A composite contract and/or package deal may contain a number of elements including leases, sales and licenses all packaged into one deal. Generally, it will be appropriate to consider the deal in its totality to understand how the various elements relate to each other, but the components of the composite contract and/or package deal may or may not, depending on the facts and circumstances of the case, need to be evaluated separately to arrive at the appropriate transfer price. In certain cases, it may be more reliable to allocate the aggregate compensation among the elements of the composite contract or package deal.

3.3.3.5 "Aggregation" issues also arise when looking at potential comparables. Since third-party information is not often available at the transaction level, entity level information is frequently used in practice when looking at external comparables (e.g. in the absence of reliable internal comparables; "external comparable" and "internal comparable" are defined in section 3.5.2 below). It must be noted that any application of the arm's length principle, whether on a transaction-by-transaction basis or on an aggregation basis, needs to be evaluated case by case, applying the most appropriate transfer pricing method to the facts in that particular case.

3.4 Examination of Comparability Factors of the Controlled Transaction

3.4.1 Overview

3.4.1.1 The first part of a comparability analysis for transfer pricing purposes involves understanding and defining the controlled transaction to be tested. In addition to the contextual information on the industry and the overall business of the taxpayer, this analysis is typically structured around five so-called comparability factors.

3.4.1.2 The factors are:

- The characteristics of the property or service transferred;
- The contractual terms; the functions performed by each of the parties (taking into account the assets employed and risks assumed);
- A functional analysis of the controlled transaction under examination;
- The economic circumstances; and
- The business strategies followed by each of the parties.

3.4.2 Characteristics of the Property or Service Transferred

3.4.2.1 Property, whether tangible or intangible, as well as services, may have differing characteristics which may lead to value and price differences in their values in the open market. Therefore, these differences must be accounted for and considered in any comparability analysis of controlled and uncontrolled transactions.

3.4.2.2 Characteristics that may be important to consider are:

- In the case of tangible property: physical features, quality, reliability, availability and the volume of supply;
- In the case of services: the nature, quality and extent of the services provided; and
- In the case of intangible property: form of the transaction (e.g. licensing or sale) and the type and form of property, duration and degree of protection and anticipated benefits from use of the property.

For example, comparability analysis should take into account the differences between trademarks and trade names that aid in commercial exploitation (marketing intangibles) as opposed to patents and know-how (trade intangibles).

3.4.3 Contractual Terms of Transaction

3.4.3.1 The conduct of the contracting parties is generally a result of the terms of the contract between them. The contractual relationship thus requires careful analysis when computing the transfer price. While there may be a written contract, the terms of the transactions may also be found in correspondence and communications between the parties involved. In cases where the terms of the arrangement between the two parties are not explicitly defined in written contracts, the contractual terms have to be deduced from the parties' economic relationship and their conduct.

3.4.3.2 An important point to note is that associated enterprises may not hold each other fully to the terms of the contract since they have common overarching interests. This contrasts with independent enterprises, which are expected to hold each other to the terms of the contract. Thus, it is important to determine whether the contractual terms between the associated enterprises are a "sham" (something that appears genuine, but when looked at more closely lacks reality, and is not valid under many legal systems) and/or have not been followed in reality.

3.4.3.3 Also, explicit contractual terms of a transaction involving members of an MNE may provide evidence as to the form in which the responsibilities, risks and benefits have been assigned among those members. For example, the contractual terms might include the form of consideration charged or paid, sales and purchase volumes, the warranties provided, the rights to revisions and modifications, delivery terms, credit and payment terms etc. In addition to an examination of these contractual terms, it will be important to check that the actual conduct of the parties conforms to them.

3.4.3.4 Where there are material differences in economically significant contractual terms between the taxpayer's controlled transactions and the potential comparables, such differences should be evaluated, in order to judge whether comparability between the controlled and uncontrolled transactions is nevertheless satisfied and whether comparability adjustments need to be made to eliminate the effects of such differences.

3.4.3.5 How contractual terms may affect transfer pricing may be seen in the following example:

Example: Relevance of Contractual Terms

Consider Company A in one country, an agricultural exporter, which regularly buys transportation services from Company B (its foreign subsidiary) to ship its product, cocoa beans, from Company A's country to overseas markets. Company B occasionally provides transportation services to Company C, an unrelated domestic corporation in the same country as Company B. However, the provision of such services to

Company C accounts for only 10 per cent of the gross revenues of Company B and the remaining 90 per cent of Company B's revenues are attributable to the provision of transportation services for cocoa beans from Company A. In determining the degree of comparability between Company B's uncontrolled transaction with Company C and its controlled transaction with Company A, the difference in volumes involved in the two transactions, volume discounts if any, and the regularity with which these services are provided must be taken into account where such factors would have a material effect on the price charged.

3.4.4 Functional Analysis

Overview of Functional Analysis

3.4.4.1 Functional analysis typically involves identification of *functions* performed, *assets* employed and *risks* assumed (also called FAR analysis) with respect to the international controlled transactions between members of an MNE. Functional analysis seeks to identify and compare the economically significant activities and the responsibilities undertaken by each of the associated enterprises and by any independent entity engaging in a potentially comparable transaction. An economically significant activity is one which materially affects the price charged in a transaction and/or the profits earned from that transaction.

3.4.4.2 Functional analysis is the cornerstone of any transfer pricing exercise. Its purpose is to gain an understanding of the operations of an enterprise in connection with its transactions with associated enterprises. The functional analysis examines the respective roles of the parties to the controlled transaction under examination. The roles undertaken by each of the associated enterprises will affect the determination of an arm's length remuneration for the controlled transaction since compensation in transactions between two independent enterprises will usually reflect the functions that each enterprise performs, taking into account assets employed and risks assumed. Generally, the more valuable those functions and assets, and the greater the risks, the greater the expected remuneration.

3.4.4.3 The functional analysis also examines the activities of the parties to uncontrolled, potentially comparable transactions. The functional analysis of parties to potentially comparable transactions will assist in evaluating whether such transactions appropriately can be utilized as comparables in the analysis since close comparability of functions performed, assets used or contributed and risks assumed is often a prerequisite for a valid comparison.

3.4.4.4 Functional analysis is a process of finding and organizing facts about the transaction in terms of the functions, risks and assets in order to identify how these are divided between the parties involved in the transaction. The functions, risks and assets are analyzed to determine the nature of functions performed, degree of risks undertaken and the nature of the assets employed by each party. This analysis helps to select the tested party/parties where needed (as explained below), the most appropriate transfer pricing method, the comparables, and ultimately to determine whether the profits (or losses) earned by the entities are appropriate to the functions performed, assets employed and risks assumed.

3.4.4.5 The functional analysis is important because the expected return of the entities involved in a transaction depends on the importance of the functions performed, the nature and degree of risks assumed and the nature and value of assets employed. Generally, the more valuable the functions performed, assets employed and the greater the risks assumed by a party to a transaction the greater its expected return (or potential loss). It is therefore extremely important to map the functions performed, assets employed and risks assumed by all the associated enterprises in relation to the controlled transaction under examination.

Example of Functional Analysis

3.4.4.6 A clearer understanding of functional analysis may be gained from the example below.

The following paragraphs describe how a functional analysis can be carried out and documented based on the example involving P Co. For these purposes it is necessary to have a qualitative description of the intragroup transactions and circumstances; this can be represented by a table as depicted in 3.T.1.

In the table, the intensity of the risks, functions and assets of a particular entity is reflected by the number of "X" assigned. Such a table can be used to summarize key aspects of a functional analysis, and to qualitatively compare the different enterprises in an MNE across a number of categories related to functions, assets, and risks based solely on the facts of a particular case. This tool is commonly referred to as a "tick chart." Tick charts, while very useful, are inherently subjective. Accordingly, the same set of facts in the hands of two different analysts may not result in identical tick charts. Caution should be used in giving tick charts quantitative significance. For example, three ticks do not reflect three times more value than a single tick. Moreover, all categories in the chart do not have equivalent weight. Accordingly, tick charts should primarily be used as a tool in evaluating qualitative aspects of the analysis, and should not be used mechanically to split profits according to the relative number of ticks.

Example: "P Co."—Energy Solutions

P Co. is a company incorporated and registered under the laws of Country A. P Co. is in the business of intelligent energy solutions and is a market leader in the development, production and supply of electronic meters and their components, software, energy monitoring, billing solutions and payment systems. Additionally, the company owns technologies related to electronic energy meters. P Co. has an established marketing networks in many developing and developed countries. P Co. is a part of MNE X, one of the largest metering consortiums in the world, which shares technology and pools the extensive experience of development and manufacture within a network covering over 30 countries.

Q Co. is a company incorporated and registered under the laws of Country B and is a wholly owned subsidiary of P Co. Q Co. intends to manufacture a wide range of electronic energy meters and portable calibrators, which would cater to all segments of the power generation, transmission, distribution and consumption sectors and offers features required for electricity revenue management. However, such equipment will have to be customized to cater to the needs of domestic users. Such adaptations would be developed by Q Co. in its own research & development (R&D) facilities.

Q Co. entered into a license agreement with P Co. to source its core technology, TECHNO A™—developed and patented by P Co. TECHNO A™, being software driven, allows cost-effective product feature enhancements and provides flexibility to utilities to effectively manage electricity revenue and demand, thereby limiting or eliminating revenue losses. TECHNO A™ technology was developed in Country A by P Co. The TECHNO A™ technology measures electricity flow using digital and microprocessor based techniques, and processes the measurements into useful information. Use of TECHNO A™ technology has major advantages in the design and manufacture of meters.

Within the above context, the controlled transactions between Q Co. and P Co. are the purchase of certain components by Q Co. from P Co. and the license of technology by Q Co. from P Co. As noted above, P Co.

is specialized in dealing with processors and other components of electronic meters and their sub-assemblies. These are critical components of an electronic meter. Q Co. manufactures energy meters in Country B and uses processors and related components purchased from P Co. Q Co. then sells energy meters to P Co., in line with its requirements.

Q Co. has its own R&D centre which tries to improve the technologies so as to achieve further efficiencies. This would mean that dependence on outside sources for technologies would be reduced in the future and cost savings could be achieved. Also, Q Co. has penetrated the market in the territory of Country B by incurring huge marketing expenditure to establish its own marketing intangibles. These are separate from the intangibles of P Co. in Country A for which a technology license agreement is in place between P Co. and Q Co.

Table 3.T.1

Qualitative Assessment of Intragroup Transactions

Symbol	Comparative risk level standards	Comparative functional level standards	Comparative asset level standard
-	No risk	No Functions	No assets
√	Lowest risk	Least Functions	Few assets
√ √	Medium risk	Lesser Functions	Medium assets
√ √ √	Highest risk	Highest Functions	Most assets

Functions Performed

3.4.4.7 **Functions performed** are the activities that are carried out by each of the parties to the transaction. In conducting a functional analysis, economically significant functions are to be considered, as such functions add more value to the transactions and are therefore expected to fetch higher anticipated returns for the entity performing such functions. Thus, the focus should not be on identifying the maximum number of functions but rather on the identification of critical functions performed by the associated enterprises.

3.4.4.8 Some of the relevant functions that are often observed and that may be economically important in determining the price for a transaction are:

- ➢ Research and development;
- ➢ Product design and engineering;

- Manufacturing, production, assembly, and process engineering;
- Purchasing, materials management and other procurement activities;
- Transportation, warehousing and inventory;
- Marketing, advertising, publicity and distribution;
- Market intelligence on technological developments; and
- Intragroup services, for example managerial, legal, accounting and finance, credit and collection, training and personnel management services.

3.4.4.9 It should be emphasized that this list is purely indicative. The extent to which each of these functions (or other functions not listed above) is economically significant and contributes to the creation of value depends on the particular facts and circumstances of the case.

3.4.4.10 A functional analysis can be approached by evaluating all the economically significant activities performed in relation to the controlled transaction under examination (such as the list indicated above) and in potentially comparable uncontrolled transactions. In general, a taxpayer should prepare this list for both parties to the relevant controlled transaction (e.g. for the producing and selling/distributing activities in this example) to ultimately support the selection of the most appropriate transfer pricing method and to assist in identifying useful comparables.

3.4.4.11 Continuing the example from 3.4.4.6, it might be hypothesized for purposes of illustration that the following are the functions performed by the respective parties.

Functions Performed by P Co.

With respect to the sale of technology and components of electronic energy meters:

In this example, it is assumed that in the context of the sale of electronic energy meters by Q Co. on the basis of the technological support of P Co., P Co. performs the following economically significant functions:

- Market development: P Co. shares its expertise with Q Co. and assists in developing presentations to the utilities (i.e. the bodies responsible for supply of power to the public) for the development of markets;
- Product development: P Co. undertakes the product development activities based on the concept developed and offered by

it to the users. Product development involves product engineering, designs, development or customization of microprocessors, observance of international standards and national standards for the product etc.; and

- Quality control: P Co. undertakes quality control processes in order to ensure that the products manufactured by Q Co. conform to contractual specifications and international and national quality standards before the products are delivered to utilities and other customers. This is a critical activity because failure to ensure quality control may invite reputational risk and product liability risk.

With respect to the import/purchase of raw materials/components by Q Co.:

It is assumed that, in connection with the purchase of processors and other components by Q Co. from P Co., the economically significant functions performed by P Co. can be summarized as follows:

- Market development;
- Market intelligence on technological developments;
- Research and development activities;
- Production planning;
- Inventory management;
- Manufacturing;
- Testing and quality controls;
- Selling and distribution activities;
- Post-sale activities including supply of replacements; and
- Technical assistance, wherever required.

Functions Performed by Q Co.

It is assumed that the functions of Q Co. in the context of the purchase of components and subsequent sale to domestic utilities are as follows:

- Market development: Q Co. undertakes market development activities. The market development activities primarily include development of the sales concept (i.e. identifying how the company can offer a customized solution to a utility having regard to the specific issues being faced by the utility concerned). Q Co. makes sales presentations to utilities in both the public and private sectors and conducts further liaison with them. Based on acceptance of the concept, pilot orders for the meters are procured by Q Co. It also participates in the tendering process to procure full commercial orders for the energy meters once the pilot runs successfully. Q Co. also carries out activities in relation to advertisement, appointment of distributors, commission agents, sales promotion, market research and marketing strategies. Also Q Co. has developed the market for the new product in the territory of Country B by incurring sizeable marketing expenditure to establish its own marketing intangibles that are separate from the intangibles of P Co. in Country A;

- Research and development: Q Co. has its own R&D centre which tries to boost its performance by improving the technologies so as to achieve further efficiencies, reducing future dependence on outside technologies and achieving cost savings;
- Production scheduling: The production by Q Co. is based on orders obtained from domestic utilities. The procurement process for the various raw materials/inputs is based on prudently prepared sales forecasts. The procurement function and the ordering processes are looked after by the "materials department". Factors like lead time, availability, negotiations etc. are taken into consideration while deciding the party from which a particular raw material/input is to be purchased;
- Tooling: The tooling activities in relation to the products to be produced are undertaken by Q Co. Different products may require different tooling. Different contract specifications may require different tooling;
- Assembly: This involves the assembling of components. Assembly operations are mechanical as well as manual. The activity involves mounting surface-mount technology components, manual inspection of placement of the components, computerized soldering of mounted components, manual inspection of the soldering process, mounting of plasma transformed arc components manually etc.;
- Intelligence loading: Intelligence loading refers to the process of loading software and other intelligence features on the manufactured meter. Q Co. undertakes this activity based on the technology and microprocessor specification of the contract;
- Testing: Testing and quality controls are critical processes in the manufacture and marketing of electronic meters. Q Co. performs testing and P Co. undertakes quality control measures. Testing activity involves temperature variation testing, testing of manufactured meters against standard meters etc.;

- Packaging and delivery: Q Co. packs the products into specially designed containers of various sizes depending on the consignment. The containers are in the form of cartons and pallet packaging. After packaging, products are delivered to domestic utilities;
- Post-sales activities: Depending on the contracts with the customers, Q Co. undertakes installation and commissioning activities wherever required under the contracts. It is also responsible for the collection of payments from customers. Contractual and non-contractual product warranties are provided to customers. Any replacement or further activities required pursuant to product performance warranties are also undertaken by Q Co.; and
- Inventory management: Q Co. is responsible for managing the procurement of raw materials/components and maintaining the requisite stock levels for the products including finished goods. As raw materials are generally product specific and the finished products are manufactured against the confirmed orders from domestic utilities, no substantial inventory management is involved.

General Management Functions

3.4.4.12 The following common functions are required to manage the business in the above example. While both parties are likely to participate in performing these functions, one may perform one or more of the functions more intensively than the other party.

- Corporate strategy determination: Generally, all policies within the MNE are determined by the management of the respective entities which continuously monitor the economic environment surrounding the entity, assess their strategic position within the industry and set targets to achieve their corporate objectives;
- Finance, accounting, treasury and legal functions: The management of the respective entity is responsible for managing the finance, treasury, legal and accounting functions. Each entity is also responsible for all local statutory compliance; and
- Human resource management function: The HR function of each entity is coordinated by its management, which is responsible for recruitment, development and training of the personnel including the pay structure.

3.4.4.13 In addition to identifying the specific functions undertaken by each party, the analysis should also evaluate the relative intensity with which each party performs its functions. Table 3.T.2. indicates one way such a qualitative evaluation of relative functional intensity might be summarized in a tick chart.

Table 3.T.2
Qualitative Relative Assessment of Functions Performed
(by P Co. and Q Co. in relation to Q Co.'s Market)

Category	**Level of Intensity**	
	A Co	**B Co**
Market development	x	xxx
Product development	xxx	xx
Manufacturing	-	xxx
Quality control	xx	xxx
Post-sales activities	-	xxx
General management functions	-	-
Corporate strategy determination	x	xxx
Finance, accounting, treasury and legal	-	xxx
Human resource management	-	xxx

Assets Used or Contributed

3.4.4.14 Assets (tangible as well as intangible) that are used by, or transferred between, the associated enterprises in the course of an international controlled transaction need to be identified as part of the functional analysis.

3.4.4.15 The analysis should involve the identification of the type of capital assets employed (e.g. plant and equipment, intangible assets, financial assets etc.) and their significance to the controlled transaction. For economically significant assets it may be necessary to perform a more detailed analysis of the assets employed, such as their age, location, property right protections available, market value etc.

3.4.4.16 In the case of capital-intensive industries, the employment of a capital asset such as property, plant and equipment, etc. is costly and has to be financed either internally or externally. However, there can also be cases where the entities are involved in activities for which the assets employed may not require such a large capital investment. Depending on the circumstances and applicable accounting standards, costs associated with acquiring rights to use an asset may be recorded as operating expenses (e.g. in the form of leasing or rental costs) or as financial expenses below the operating profit line (e.g. as interest expenses). Where an operating profit measure is used to determine if the controlled transaction(s) are arm's length, it will be important to ensure such amounts are considered in the comparability analysis and that their accounting treatment is consistent. Adjustments might be required to ensure consistency of accounting standards between the controlled transaction and the comparable. Differences in the use of assets can sometimes be eliminated or reduced to a significant extent by making comparability adjustments on account of working capital or capacity utilization.

3.4.4.17 Where the transactions involve the use or transfer of economically significant intangibles, the special considerations set out in Chapter 6 should be borne in mind.

Tangible Assets

3.4.4.18 It can be hypothetically assumed for the purpose of the example that B Co. owns the following tangible assets. In any actual case the list of relevant economically important assets would depend on the specific facts of the case.

- Land and buildings;
- Plant and machinery;
- R&D equipment;
- Office equipment;
- Furniture and fixtures;
- Vehicles;
- Computers; and
- Testing equipment.

Intangible Asset Ownership

3.4.4.19 It can be assumed for purposes of the example that:

- Q Co. has established a research and development department which tries to increase the level of its performance by improving technologies so as to achieve further efficiencies. This would also reduce dependence on outside sources of technology in the future and achieve cost savings. The department also conducts R&D programmes to support Q Co.'s business and to provide technical assistance to its customers. These efforts help to increase production efficiency and product quality;

- Q Co. has established its own marketing intangibles in Country B by incurring significant expenditure on marketing and has penetrated the market for the new product in the territory of Country B. As noted above, these marketing intangibles are separate from the intangibles of P Co. in Country A for which a technology agreement is in place with P Co.;
- Q Co. has entered into a technology license agreement with P Co. for procuring technology for the manufacture of specified products. Thus Q Co. uses the process, know-how, operating/ quality standards etc. developed/owned by P Co. Q Co. leverages value from these intangibles for continued growth in revenue and profits;
- P Co. is the market leader in the development and supply of electronic meters, as well as related software, energy monitoring, billing solutions and payment systems. Over the years the company has amassed a wealth of proprietary technical knowledge. This includes product specifications, designs, the latest manufacturing processes and empirical data on the usage of products by customers in the industry;
- P Co. enjoys a reputation for quality products. In the international utility markets, product supplies from international players from developed countries are preferred by the customers and utilities as compared to direct product supplies from suppliers located in developing countries. Q Co. leverages on P Co.'s established brand name and reputation for high technology products. P Co.'s commitment to quality also provides Q Co. with an edge while selling products in the domestic markets.

3.4.4.20 In addition to identifying the specific assets used or contributed by P Co. and Q Co, the functional analysis should evaluate the relative importance of the asset contribution of each party. Table 3.T.3. indicates one way such a qualitative evaluation might be summarized.

Table 3.T.3

Summary of Assets Employed

Category	**Level of Intensity**	
	P Co	**Q Co**
Tangible assets	xx	xxx
Intangible assets	xxx	xx

Table 3.T.3 (continued)		
Category	**Level of Intensity**	
	P Co	**Q Co**
- Technological	xxx	
- Brand	x	x
- Legal	x	xxx

Risks Assumed

3.4.4.21 Risk analysis is an important part of the functional analysis. The detailed guidance provided in this section on the analysis of risks as part of a functional analysis does not mean that risks are more important than functions or assets. The relevance of functions, assets and risks in a specific transaction will need to be determined through a detailed functional analysis.

3.4.4.22 Risks are an inherent part of commercial activities. Businesses exist and undertake commercial activities in order to pursue opportunities to make profits. Simply put, risk is the effect of uncertainty on the objectives of the business. Greater risks are associated with higher expected returns—profit-seeking enterprises would only take on the risks in commercial opportunities if they anticipate a positive return. But such opportunities are inherently uncertain: costs may be higher than anticipated; revenues may be lower; circumstances may change and therefore actual results may be better or worse than those which were expected.

3.4.4.23 Since the assumption of economically significant risks will be relevant to the pricing of a transaction, a transfer pricing analysis must first identify such risks, and then determine which entity assumes them. This analysis of risk should start from the contractual terms that exist between the parties but should also have regard to the conduct of the parties, including the functions they perform and any other relevant facts. Only then can the controlled transaction be properly understood and defined, and from there, appropriately priced. For transfer pricing purposes, the analysis of risk can be broken down into six steps.

STEP 1: Identification of Economically Significant Risks

3.4.4.24 There are many sources and types of risk, the significance of which will vary depending on the nature of the business transaction. The significance of a risk will depend on a combination of its likelihood and its potential impact on the profits (or losses) of the business. For example, the risk associated with the design of new packaging to improve visibility of a product may be relatively small compared to the risk associated with the development of a completely new product line. Changes to a "flagship" product are likely to carry more risk than changes or variations to a less important product or to one product among many sold by the business, and risks associated with developments based on novel technologies or wholly new applications are likely to be higher than those which build on existing, proven products or technologies.

3.4.4.25 An examination of the key functions and commercial context of a transaction will help to identify significant risks. In many cases, an examination of the functions performed, assets used or contributed and risks assumed by other associated enterprises in the MNE contributing to the group's creation of value may help in this process since risks also represent opportunities and businesses will generally allocate resources to manage significant risks.

3.4.4.26 An illustrative list of risks that may be assumed by the parties to the transaction is provided below. However, the relevance and significance of each individual risk factor listed below will depend on the nature of the individual transaction and the particular facts of the individual case.

Table 3.T.4
Illustrative List of Risks Assumed

Nature of risks	**Particulars**
Financial risk	a. Method of funding
	b. Fluctuation in interest rates
	c. Funding of losses
	d. Foreign exchange risk
Product risk	a. Design and development of product
	b. Upgrading/obsolescence of product
	c. After sales service
	d. Risks associated with R&D
	e. Product liability risk
	f. Intellectual property risk
	g. Scheduling risk
	h. Inventory risk
Market risk	a. Development of a market including advertisement and product promotion, etc.
	b. Fluctuation in demand and prices
	c. Business cycle risk
	d. Volume risk
	e. Service incentive scheme risk
	f. Asset redundancy risk

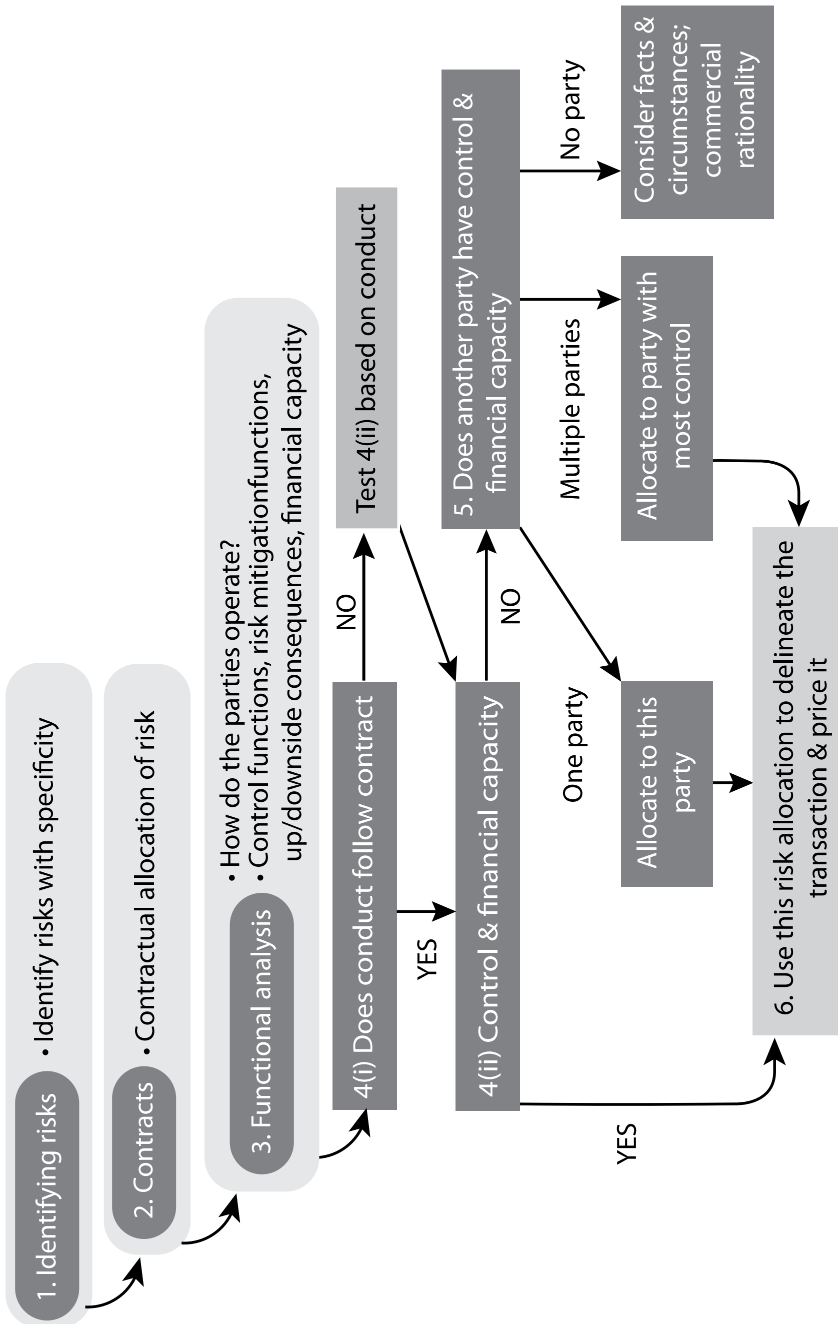
Table 3.T.4 (continued)	
Nature of risks	**Particulars**
Collection risk	a. Credit risk
	b. Bad debt risk
Entrepreneurial risk	a. Risk of loss associated with capital investment
	b. Single customer risk
	c. Risk of losing human capital intangible
General business risk	a. Risk related to ownership of property
	b. Risk associated with the exploitation of a business
	c. Inflation risk
Country/regional risk	a. Political risk
	b. Security risk
	c. Regulatory risk
	d. Risk related to government policies

3.4.4.27 It should be emphasized that this list is purely illustrative, and that the extent to which each of these risks (or other risks not listed above) is economically significant and contributes to the creation of value depends on the industry and on taxpayer-specific circumstances. Hence, real life knowledge of how a particular MNE is functioning *vis-à-vis* its associated enterprise is very crucial in determination of the risk. For instance, not all industries involve the same level of product liability risk.

STEP 2: Contractual Assumption of Risk

3.4.4.28 Once economically significant risks have been identified, the analysis turns to consideration of which party assumes such risks. In this regard, the starting point for the analysis is usually the contractual terms between the parties (STEP 2). Parties transacting at arm's length would be expected to agree on the allocation of significant risks between them before the outcome of the risk-taking is known. However, contracts between associated enterprises may not specify the allocation of all the economically significant risks.

Figure 3.D.1
The Process of Delineating and Pricing Transactions



Most of the commonly assigned risks in the contract are risks which can be mitigated against, for example inventory risk, bad debts, foreign exchange risk etc. Market circumstances, price competition, the supply of raw materials, rises in wages etc. are risks which typically are more difficult to mitigate, and which may not be identified in the contract. Volatility in the global market in the past decade has demonstrated that risks which are difficult to mitigate are often economically more significant than the kinds of contractual risks as mentioned above.

3.4.4.29 Moreover, in some cases, written contracts may be inconsistent or may not be followed in practice. For example, a contract may say that a manufacturer of electronic goods bears warranty risk; however, in practice the reseller habitually pays for the cost of customer repairs made under warranty. In this case, it is the reseller that is bearing the risk. The determination of the risk assumption between the parties must therefore be based on the actual conduct of the parties, rather than merely to the legal form of the agreement.

3.4.4.30 Even where a comprehensive and consistent contract is in place, an analysis of the conduct of the parties and other facts is critical. In particular, it is important to consider which party or parties control the economically significant risks, and whether a party assigned a risk in fact has the financial capacity to assume it. Both control (see sections 3.4.4.33 to 3.4.4.35) and financial capacity (see sections 3.4.4.36 to 3.4.4.38) are necessary for one party to be treated as having assumed a particular risk; but neither of them is by itself sufficient.

STEP 3: Functional Analysis in Relation to Risk

3.4.4.31 The next step in the risk analysis process gathers facts on the actual conduct of the parties through a functional analysis. As has been noted above, information relating to the exercise of control over risk and the financial capacity to assume risk are particularly important. This information will then be analyzed in the remaining steps.

Control Over Risk

3.4.4.32 While it may be impossible to eliminate or even influence some risks, economically significant risks are central to the success or failure of commercial operations, and thus commercial enterprises generally devote substantial resources to managing significant commercial opportunities and their inherent risks.

3.4.4.33 In a transfer pricing analysis, "control" over a risk has a specific meaning. It is:

(1) The capability to make decisions to take on, lay off or decline a risk-bearing opportunity, together with the actual performance of that decision-making function;

(2) The capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function; and

(3) Either the performance of risk mitigation functions (i.e. taking measures that affect risk outcomes) or, if risk mitigation is outsourced to another party (whether associated or independent), the capability to determine the objectives of the outsourced activities, to decide to hire the provider of those activities, to assess whether the objectives are being adequately met, and where necessary, to decide to adapt or terminate the contract with the provider; together with the actual performance of such assessment and decision-making.

Example: Clothing Manufacturer

Company X runs a clothing manufacturing facility. It enters into a contract with Company Y to manufacture children's pyjamas on Y's behalf. The design and pattern for the pyjamas are provided by Company Y. Company Y also specifies the sizes and number of pyjamas to be produced, as well as timing of production. Company X is required to manufacture the pyjamas to Y's specifications, including meeting Y's quality standards and using materials approved by Company Y. Company Y undertakes quality control audits to ensure that the pyjamas produced by X meet those specifications, and provided that is the case, it guarantees to buy all the pyjamas produced by X as specified under the contract. The contract also states that, provided X meets the quality control standards set out by Y, Y will indemnify X against any warranty or compensation claims which may arise from the sale of the pyjamas.

In this example, the economically significant risks are identified as the inventory risk and warranty/ product recall risk. In respect of both of these, Company Y has the capability and actually performs the decision-making functions regarding what to produce and when, and it sets and actively monitors the quality control standards and other specifications. Y can therefore be said to control these risks.

3.4.4.34 Control over risk involves the process of real decision-making. Decision-makers must be able to understand the risk and the impact the decision could have on the business. They must have access to relevant information. If information or analysis is provided by others, the decision-maker must be able to assess whether the right information has been provided, and whether the analysis being relied upon are adequate. Without the foregoing, the mere formalization of a decision, for example in the form of the signing of documents or the minutes of a meeting reflecting a decision effectively already made elsewhere, are insufficient.

3.4.4.35 The setting of the broad policy framework in which to assess risks is also not enough. For example, the setting by Company Y of broad MNE objectives or a general company "image" would not mean that Company Y controls risks relating to specific marketing strategies. Similarly, a requirement to analyze and report on certain risks in a certain way, or in accordance with a particular framework or template, does not necessarily constitute control over risk for the purposes of a transfer pricing analysis.

Example: Control Over Risk by Parent Company

Company A situated in Country Z belongs to an MNE group with operations worldwide through various subsidiaries. Company A is responsible for the overall research programmes of the group. The group has two R&D centres operated by Companies B and C, both subsidiaries of Company A and situated in Countries X and Y respectively. Risks relating to R&D are identified as economically significant (STEP 1).

Company A employs a workforce that includes the Chief Executive Officer, Chief Financial Officer, senior management and technical personnel that provide strategic supervision of the group's R&D activities. Company A claims that it controls and takes all strategic decisions with regard to the core functions of Companies B and C. The contractual arrangements between the companies support this (STEP 2).

STEP 3 Functional analysis: Company A designs and monitors the MNEs overall research programmes, making the decisions regarding which areas of research to pursue, as well as setting the objectives of the research. Company A establishes a reporting and analysis framework against which Companies B and C must provide information on the progress of the research activities. It also provides funds needed for R&D activities and controls the annual budget for R&D activities of Companies B and C. The CEO, CFO and other senior management personnel of Companies B and C reside in Countries X and Y and are technically and functionally competent to take decisions and carry out the R&D activities of Company B and C, under the overall direction of Company A. The technical manpower needed for R&D activity and the assets of Companies B and C are located in Countries X and Y.

Company A claims that it controls the risk of the R&D activities of its subsidiaries. On inquiry, it is found that the personnel managing the group's R&D activities in Company A in Country Z are experienced and qualified to make decisions on and to monitor the R&D activities of Companies B and C, and that they in fact do so, based on regular reports provided by B and C on the progress of the research, which Company A evaluates. In addition, Company A has furnished evidence that it has covered the costs of Companies B and C's R&D activities in all the instances where such activities did not lead to successful outcomes. It was also noted that Companies B and C actually perform R&D functions and take the decisions required for performing the day-to-day functions of R&D.

STEPS 4-6 Analysis and conclusions: In this example, while the actual functions of R&D activities are undertaken in Countries X and Y, Company A contractually assumes the risk related to the ultimate success or otherwise of the R&D activity and has demonstrated that it has the capability to control, and actually controls these risks through its strategic decisions and monitoring activities and through bearing the losses from unsuccessful R&D programmes. Provided Company A has the financial capacity to assume these risks, it will be concluded that Company A assumes the risks associated with the success or failure of the research activity undertaken by Companies B and C. Companies B and C, which perform operational R&D activities and take the decisions necessary to perform these day-to-day functions of R&D and also bear the related operational risk, should be entitled to an appropriate return for these functions and risks.

Company A, which provides the strategic direction and management of the group's R&D activities, funds the group's R&D activities and exercises control over the risk of unsuccessful R&D activity, should be entitled to an appropriate return for its functions and risks. Company A should be entitled to the returns from the intangibles (if any) associated with the R&D, less the appropriate returns to Companies B and C.

Example: Control Over Risk by Subsidiaries

Company A situated in Country Z, a low-tax/no-tax jurisdiction, belongs to an MNE having operations worldwide through various subsidiaries. Company B and C, which are both subsidiaries of Company A, operate R&D centres situated in Country X and Y respectively, having normal tax rates. Risks relating to R&D were identified as economically significant (STEP 1). Company A, which employs a workforce of ten persons including a CEO, CFO and other senior management, claims that it controls and takes all strategic decisions with regard to the core functions of companies B and C. The contractual arrangements between the companies support this (STEP 2).

STEP 3 Functional analysis: Company A provides the funds needed for R&D activities and controls the annual budget for such activities of Companies B and C. It also provides technical assistance for registration of patents in Countries X, Y and Z. The CEO, CFO and other senior management personnel of Company B and C reside in Countries X and Y and are technically and functionally competent to take decisions and carry out R&D activities of Company B and C. The technical manpower needed for R&D activity and the R&D related assets of Companies B and C are located in Countries X and Y.

Company A claims that it controls the risk of the R&D activities of its subsidiaries. Upon audit it was found that the CEO and CFO and senior management of Company A in Country Z do not have the technical skills and experience to take strategic decisions regarding the direction of the R&D activities, or to monitor those activities. Company A has not furnished any evidence that it takes strategic decisions relating to the R&D programmes of Companies B and C. On the other hand, it was found that the senior management of Companies B and C are taking the important strategic decisions related to the design and direction of the R&D programme and budget, including determining the objectives of the research and evaluating which areas of research to pursue. However, Company A has furnished evidence that the funds were actually transferred to its subsidiaries for R&D activities.

STEPS 4-6 Analysis and conclusions: In this example all the core functions of R&D activities are located in Countries X and Y and the non-core functions of registering patents are located in Country Z. Even though the senior management of Company A are located in Country Z they are not capable of taking strategic decisions or controlling and monitoring R&D activities and do not, in fact, do so. The determination, utilization and control of the budget for carrying out R&D activities and decisions regarding day-to-day performance of R&D activities were carried out by Companies B and C. In view of these facts it cannot be upheld that Company A controls the risk of R&D activities. Company A should be entitled to an appropriate return for the provision of funding and Companies B and C should be entitled to an appropriate return for their functions including the strategic decisions and control over the risk of R&D activities.

Note that in this example, the conclusion would have been the same even if Company A had been a resident of a high-tax jurisdiction.

Financial Capacity to Assume Risk

3.4.4.36 Where a risk has materialized it will be a question of fact as to which party bore the consequences. However, since any analysis of risks must take into account temporality (i.e. past risks where outcomes are known are no longer risks at all), it will be relevant to consider whether a party has the financial capacity to assume a risk. Financial capacity to assume risk can be defined as access to funding to take on or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if it materializes. Access to funding takes into account the available assets of the party, as well as the options realistically available to it to access additional liquidity, if needed, to cover the costs anticipated to arise should the risk materialize. The consideration of whether an entity has the necessary financial capacity should be done on the basis that it is operating as an unrelated party in the same circumstances as the entity. For instance, if an entity has the right to exploit income-generating assets, it is likely to be able to access liquidity against its income stream.

3.4.4.37 It should be noted that the financial capacity to assume the risk is not necessarily the financial capacity to bear the full consequences of the risk materializing (e.g. the full loss): the risk-bearer may have the capacity to protect itself from the consequences of the risk materializing (e.g. by hedging the risk or insuring against the impact of the risk). However, because financial capacity to assume a risk is not by itself sufficient to assume a risk, a high level of capitalization does not necessarily mean that the highly capitalized party assumes the risk.

3.4.4.38 It is relevant to mention here that in a multinational enterprise associated entities may work together to exert control over the risks of the entire MNE group. Precise distribution of risk among the associated enterprises may be extremely difficult to achieve. The transfer pricing analysis regarding which entity assumes certain risks should therefore be done considering all the facts and circumstances of each case.

STEPS 4-6: Analyzing the Information Gathered to Draw Conclusions on Assumption of Risk

3.4.4.39 Steps 4 to 6 of the risk analysis framework analyze the information gathered in the earlier steps to determine the assumption of risk for the purposes of the transfer pricing analysis.

3.4.4.40 In cases where the contractual assumption of risk is fully supported by the parties' conduct, including an alignment with the exercise of control and financial capacity to assume the risk, the analysis will be straightforward. That is, where a party, which is assigned a risk under a consistent contract (i.e. one that is followed in practice) (STEP 4(i)) also controls that risk and has the relevant financial capacity (STEP 4(ii)), it will be regarded as assuming the risk for the purposes of understanding and defining the transaction and pricing it under a TP analysis (STEP 6). The fact that another party also performs control functions or has financial capacity will not affect the determination of the assumption of risk under the transfer pricing analysis. In some cases, risks may be contractually shared by more than one party.

3.4.4.41 In other cases, where the contractual assumption of risk is not aligned with the exercise of control or the financial capacity to assume the risk, the analysis will require an additional step (Step 5). That is, where a party is contractually assigned a risk (or is made to actually bear the costs of the risk when it materializes) (STEP 4(i)) but does not control it, or does not have the relevant financial capacity (STEP 4(ii)), it cannot be regarded as truly assuming the risk. Instead, the party which does exercise control over the risk and has the relevant financial capacity should be allocated the risk (STEP 5). If multiple associated enterprises are identified that both exercise control and have the financial capacity to assume the risk, then the risk should be allocated to the associated enterprise or group of enterprises exercising the most control. This allocation of risk is what should be used to define the transaction and determine the arm's length price for transfer pricing purposes (STEP 6). The other parties performing control activities should be remunerated appropriately, taking into account the importance of the control activities performed.

3.4.4.42 In exceptional cases, it may be the case that there is no party that both exercises control and has the financial capacity to assume the risk. Such a scenario would rarely occur between independent enterprises and therefore a thorough analysis should attempt to identify the reasons for this. An assessment of the commercial rationality of such a transaction may be necessary (see sections 3.3.2.3 to 3.3.2.6 above).

3.4.4.43 The assumption of risk based on the analysis above should be compensated with an appropriate anticipated return. Normally, this means that the party or parties assuming the risk will enjoy the potential upside consequences resulting from the playing out of the risk, for example, the profits that result from a successful venture risk; but would also bear the potential downside consequences if the risk materializes resulting in greater costs or lower than expected profits. In a proper transfer pricing analysis, associated enterprises should always be appropriately remunerated for their contributions — the functional analysis considers functions and assets and not only risks. For example, parties performing risk mitigation functions on behalf of an entity assuming risk should be adequately compensated at arm's length for those functions. Similarly, where a party is performing control functions, this should be taken into account even if it does not assume the risk relating to those control functions. The form of this compensation will depend on the arrangements between the enterprises and the nature of the contribution: it may be appropriate for such a party to share in the potential upside and downside consequences resulting from the playing out of the underlying risk. Alternatively, the contribution might be compensated in a manner that is not contingent on the underlying risk.

3.4.4.44 Continuing the example from section 3.4.4.6, it is assumed for the purpose of the example that the following are the risks assumed by the respective parties.

Table 3.T.5

Risk Assumption—Exposure and Control Decisions

Risk Category	**Exposure and Control Decisions of P Co**	**Exposure and Control Decisions of Q Co**
Product liability risk	It is assumed that P Co. faces this risk arising from the product failure, technology absorption by Q Co. and consequential reputational risk. Further, P Co. is primarily engaged in product and technology development, and makes all the relevant control decisions thereto, so this risk is also assumed by P Co.	It is assumed that Q Co. faces product liability risk as a result of rejection where the products do not conform to the order specification given by domestic power utilities. Since Q Co makes the relevant control decisions relating to conformity with customer specifications or national/international product

Table 3.T.5 (continued)

		standards, these risks are assumed by Q Co. Q Co. mitigates this risk by taking steps to ensure excellent quality and safety standards and processes are deployed and by having its own R&D centre.
Technology risk	P Co. is the technology owner. Due to market competition and an ever-changing technology scenario, the company needs to continuously upgrade its existing technology and develop new technology. P Co. makes these control decisions and continuously focuses on providing products with contemporary technology. It can thus be concluded that P Co. assumes the technology risk.	It is assumed that the manufacturing operations of Q Co. are non-complex. Further, product technology and know-how have been provided by P Co. Hence, Q Co. does not assume any major technology risk.
Research and development risk	It is assumed that since P Co. serves diverse markets, its engineering and R&D professionals constantly strive to provide innovative solutions that offer competitive advantages for customers worldwide. These activities include the control decisions relating to R&D risk. P Co. thus assumes the R&D risk in this case.	It is assumed that since no significant R&D (except for supporting Q Co.'s business and that of providing technical assistance to its customers) is carried out by Q Co., it assumes no significant risk on this account.
Credit risk	As P Co. is not involved in decisions relating to the extension of credit to customers, it does not assume any significant credit risk.	Since Q Co. is responsible for decisions relating to the extension of credit to customers, all the major credit risks associated with sales are assumed by Q Co.
Inventory risk	As P Co. is primarily engaged in product and technology development, and is not involved in inventory management, this risk is not assumed by P Co.	Q Co. is responsible for managing the procurement of raw materials/ components and maintenance of requisite stock levels for each product including finished goods. This risk

Table 3.T.5 (continued)

		is mitigated to the extent that components are procured from P Co.
Foreign currency risk	P Co. exports technology and components to Q Co.; hence they are also subjected to appreciation/depreciation of local currency against the foreign currency. The assumption of this risk will depend on which party makes the relevant control decisions regarding currency, including the use of any hedging instruments to mitigate such risk.	It is assumed that since Q Co. imports technology and components from P Co. and its sales are restricted to domestic markets, the imports are subjected to appreciation/depreciation of local currency against the foreign currency. The assumption of this risk will depend on which party makes the relevant control decisions regarding currency, including the use of any hedging instruments to mitigate such risk.

3.4.4.45 Based on the foregoing, the risks assumed by P Co. and Q Co., combined with a qualitative evaluation of the intensity of those risks, can be summarized in a table like the one below. It should be emphasized that one type of risk may be more important or have a larger economic impact on prices than another type of risk. Thus, P Co.'s technology risk may affect pricing far more than Q Co.'s inventory or credit risk, even though all three types of risk are assigned three ticks in the chart. Thus, this type of summary cannot be used as a mechanical tool for allocating profit.

Table 3.T.6

Summary of Risks Borne by Each Party

Category	**Level of Intensity**	
	A Co	**B Co**
Market risk	-	-
Product liability risk	-	xxx
Technology risk	xxx	x
Research and development risk	xxx	xx
Credit risk	-	xxx
Inventory risk	-	xxx
Foreign currency risk	xx	xx

3.4.5 Economic Circumstances of the Transaction

General

3.4.5.1 Economic analysis deals with industry analysis and the circumstances that may be relevant for determining market comparability. The relevant information on the industry can be broadly classified as follows:

- Global economic trends and developments relating to the industry to which the enterprise belongs;
- Economic trends in each taxpayer's country for the same industry; and
- Market position of the enterprise and surrounding economic conditions.

3.4.5.2 Care must be exercised while considering global economic trends, as the market trends in the taxpayer's country and in the country of its associated enterprise and/or of the potential comparables (in the case where foreign comparables are used) could be significantly different. For example, in the 2008 global financial crisis some of the banks and automobile companies reported huge losses globally, but significant profits in emerging economies. Where there are such significant differences between the economic circumstances prevailing in different markets such that it is not possible to eliminate them by making reliable comparability adjustments, then companies from such different markets might not be retained as reliable comparables.

3.4.5.3 Undertaking a more detailed classification of the above broad headings may suggest that the following specific factors should be evaluated in performing an industry analysis if they are economically significant for the examined controlled transaction:

- Geographic location of the market;
- Market size;
- Level of the market (e.g. retail or wholesale);
- Competition in the market and the relative competitive positions of the buyers and sellers;
- Availability of substitutes;
- Government regulations of the market;
- Levels of supply and demand;
- Consumer purchasing power;
- Location-specific costs of production including the costs of land, labour, capital, transportation costs etc.;

- Economic conditions of the overall industry, the key value drivers in the industry and the date and time of transactions;
- The existence of a cycle (economic, business or product cycle); and
- Other relevant factors.

3.4.5.4 Market prices for the transfer of the same or similar property may vary across different markets owing to cost differentials and/or differences in purchasing power and habits prevalent in the respective markets which may affect the market price. Markets can be different for numerous reasons; it is not possible to itemize exhaustively all the market conditions which may influence transfer pricing analysis but some of the key market conditions which influence such an analysis are discussed below.

3.4.5.5 In general, uncontrolled comparables would first be sought from the geographic market in which the controlled taxpayer operates, because there may be significant relevant differences in economic conditions between different markets. If reliable comparables from the same market are not available, an uncontrolled comparable derived from a different geographical market may be considered if it can be determined that (i) there are no differences between the two markets that would materially affect the price or profit of the transaction or (ii) reasonably reliable adjustments can be made to account for such material differences between the two markets.

Location Savings

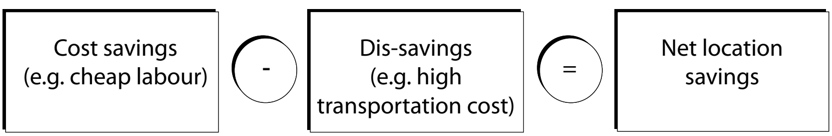
3.4.5.6 An example of a potential issue relating to geographic location is that of "location savings", which may come into play during a transfer pricing analysis. Location savings are the net cost savings that an MNE realizes as a result of relocation of operations from a high-cost jurisdiction to a low-cost jurisdiction. Typically, the possibility to derive location savings may vary from one jurisdiction to another, depending for example on the following:

- Labour costs;
- Raw material costs;
- Transportation costs;
- Rent;
- Training costs;
- Subsidies;
- Incentives including tax exemptions; and
- Infrastructure costs.

3.4.5.7 It is quite possible that part of the cost savings may be offset at times by "*dis-savings*" on account of the poor quality and reliability of the power supply, higher costs for transportation, quality control etc. Accordingly, only the net location savings (i.e. savings minus dis-savings) may give rise to an extra profit arising to an MNE due to the relocation of its business from a high-cost to a low-cost jurisdiction.

3.4.5.8 The computation of location savings typically involves the quantification of the net cost savings derived from relocating in a low-cost country, as compared to the relevant high-cost country. In theory, the cost savings computation includes selection of a pre-transfer manufacturing or servicing base in the relevant high-cost country compared to the comparable manufacturing or services cost in the low-cost country, taking into account such things as total labour cost per unit of output (adjustment on account of difference in labour productivity), cost of raw material, costs of land and rent costs; tax benefits etc. The cost savings can be partially offset by higher cost of infrastructure such as less reliable power supplies etc. in certain cases.

Figure 3.D.2
Determining Net Location Savings

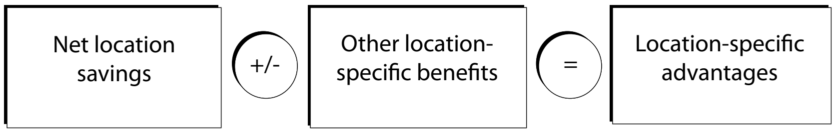


3.4.5.9 Location-specific advantages and location savings are defined as a type of benefit related to geographical location. The relocation of a business may in addition to location savings give some other location-specific advantages (LSAs). These LSAs could be, depending on the circumstances of the case:

- Highly specialized skilled manpower and knowledge;
- Proximity to growing local/regional market;
- Large customer base with increased spending capacity;
- Advanced infrastructure (e.g. information/communication networks, distribution system); or
- Market premium.

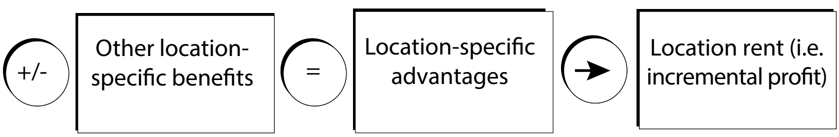
3.4.5.10 Taken together, location savings and each of the other types of benefit related to geographical location are called location-specific advantages (LSAs). LSAs may play a very important role both in increasing the profitability of the MNE and in determining the bargaining power of each of the associated enterprises. It should be noted that the term LSA includes sources of value that are discussed elsewhere in the Manual, and should not be double-counted in assessing arm's length outcomes. LSAs can be measured as follows:

Figure 3.D.3
Determining Location-specific Advantages



3.4.5.11 The incremental profit, if any, derived from the exploitation of LSAs is known as "location rent". Thus, the term "location savings" represents "cost savings" whereas "location rent" represents the incremental profits derived from LSAs. The value of "location rent" is at most equal to, or less than, the value of LSAs.

Figure 3.D.4
Determining Location Rent



3.4.5.12 The extent to which LSAs will lead to location rents depends on competitive factors relating to the end product and to the general access to LSAs. It is possible that in a particular case, even though LSAs exist, there are no location rents. For example, in situations in which the market for the end product is highly competitive and potential competitors also have access to the LSAs, much or all of the benefits of LSAs would be passed on to the customers through lower prices of products, resulting in little or no location rent. However, circumstances where extra profits are passed on to customers are varied, and may be permanent or temporary. Where this is temporary, at the end of this period of competition, the MNE may possibly achieve a larger market share in the local market with an increased ability to sell products at a higher price. Alternatively, if an MNE has exclusive access to the LSAs, then the MNE may derive significant location rents associated with the LSAs, as the LSAs reflect a competitive advantage. These location rents may dissipate over time due to competitive pressure, depending on the facts and circumstances of each case.

3.4.5.13 As with the determination of whether location rents exist, the arm's length attribution of location rents depends on competitive factors relating to access to the LSAs, and on the realistic alternatives available to the associated enterprises given their respective bargaining power. To the extent that competitors would not have access to the LSAs, the relevant question is why this is so. There are a number of possibilities. For example, the MNE could have production intangibles that allow it to manufacture at a lower cost than competitors. At arm's length, the owner of the intangible would typically be entitled to the rents associated with this cost saving, as it would have a realistic alternative to undertake its production elsewhere at similarly low costs. As another example, it might be that the low-cost producer is the first to operate in the low-cost jurisdiction and there are no comparable low-cost producers in its jurisdiction or other jurisdictions, implying that, for a time at least, it is well-placed to extract a part of the location rents.

Other Relevant Factors

3.4.5.14 The next question would be the appropriate split consistent with the arm's length principle. As discussed above, the bargaining power of the associated enterprises which reflects the arm's length nature of two independent parties negotiating over their respective shares of savings/rents may be well suited as the key metric for this. This can be used to determine the arm's length surplus (savings/rents) allocations when comparable uncontrolled transactions or benchmarks are not available.

3.4.5.15 Government rules and regulations should be treated as conditions of the market in the particular country if they apply in the same way to controlled and uncontrolled transactions. Such rules would include government interventions in the form of price controls, interest rate controls, exchange controls, subsidies for certain sectors, anti-dumping duties etc., and should be taken into account in arriving at an appropriate transfer price in that market. The question becomes whether, in light of these conditions, the transactions between associated enterprises are consistent with comparable uncontrolled transactions between independent enterprises.

3.4.5.16 An example of where government rules affect the market is that of certain pharmaceutical formulations, which may be subject to price regulation in a particular country. Another example is Export Oriented Units which may be subject to beneficial provisions under the taxation laws of a country; ideally, companies that enjoy similar privileges should be used as comparables, and if that is not possible, comparability adjustments may need to be made as part of the comparability analysis. Another example is where foreign exchange regulations limit the amounts of the payments that can be made for services or intangibles. However, such regulatory limits may not set arm's length prices for services or intangibles. For example, assuming that all the transactions are denominated in the same currency, certain countries have restrictions on the payment of interest on external commercial borrowings and the exchange control regulatory requirements authorize the borrower to pay interest at LIBOR plus say 200 basis points. The country of the lender may, however, not agree to use this as a basis for benchmarking the transaction when the lending enterprise itself borrows in its domestic market at a higher rate.

3.4.5.17 The market level of the company is another key factor. For example, the price at the wholesale and retail levels would generally differ so that a retail price should not be compared to a wholesale price. Other market conditions which may influence the transfer price may include: costs of production (including costs of land, labour and capital); availability of substitutes (both goods and services); level of demand/supply: transport costs; the size of the market, and the extent of competition.

3.4.6 Business Strategies

3.4.6.1 On a general level, business strategies are one of the important factors in a comparability analysis. However, the examination of the legitimate business strategy of an MNE will depend on the facts and circumstances of each case. The business strategy of an MNE is dependent upon the structural characteristics of its industry. Nonetheless, MNEs with different business strategies may exist within the same industry. The business strategies pursued by different MNEs may differ because of their different levels of global integration, different corporate histories, internal efficiencies and competitive advantages. Business strategies would take into account many aspects of an enterprise such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, the impact of existing and planned labour laws, duration of arrangements and other factors bearing upon the daily conduct of business. Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions.

3.4.6.2 On a strategic level, market share improvement strategies considered by MNEs can be divided into the following three main categories depending on the period of their existence in a market:

- Market penetration strategy;
- Market expansion strategy; or
- Market maintenance strategy.

3.4.6.3 The above market share strategies depend on various factors like market power and the business life cycle of the MNE in a particular market. Market penetration occurs when an MNE is a relative newcomer to a particular market and is seeking to enter and establish its products/services in the new market. An MNE might actively pursue a market expansion strategy to increase its market share in highly competitive markets. Market maintenance occurs when an MNE has already entered a market and is aiming at maintaining its market share.

3.4.6.4 A market penetration strategy may involve a combination of strategies for attracting existing users of a competitive brand to new products and attracting non-users to the product category to which the new product belongs.

3.4.6.5 When an MNE pursues a market maintenance/expansion strategy it may focus on combining multiple strategies of:

- Attracting users of competitive brands;
- Pursuing current users to increase usage; and
- Attracting non-users of the product category.

3.4.6.6 All these three market share strategies use two fundamental tactics:

- Lowering the price of their products on a temporary basis by offering discounts on the product to become extremely competitive in the market; and
- Increasing marketing and selling expenses through increased advertisement; sales promotion activities like offering rebates, free samples, offering extended warranties, and increased marketing activities such as increasing the number of salespersons, commission agents or distributors and increasing the amount of incentive payments made to commission agents or distributors.

It may be desirable to isolate the costs related to the pursuit of the above tactics as precisely as possible so that the allocation of costs at arm's length can be computed.

3.4.6.7 Market penetration, market expansion and market maintenance strategies are legitimate business strategies that may involve substantial costs, sometimes resulting in significant losses. Accordingly, there is strong implicit recognition that market share strategies cannot be pursued indefinitely by a taxpayer and there has to be some definite time frame in the foreseeable future when these strategies might yield profits. A transfer pricing analysis should consider the arm's length allocation of the costs of these strategies between an MNE and its subsidiaries. The appropriate allocation of the costs of such strategies will depend on the facts and circumstances of each case. It is important to examine the following factors in order to determine the proper cost allocation between parties to cross-border transactions:

- Which entity is the initiator of the strategy?
- Which entity is the intended beneficiary of the strategy?
- Are unusually intense advertising, marketing and sales promotion efforts taking place, since these would provide a signal of market penetration or market share expansion strategies;
- What is the nature of the relationship between the related parties, i.e. their responsibilities and risk profile?
- Does the strategy involve intangibles? and
- Which party is the legal and economic owner of such intangibles?

3.4.6.8 For example, a limited risk company acting solely as a sales agent with little or no responsibility for market development would be less likely to share the costs of a market penetration strategy initiated by its parent company than would a full risk distributor that might benefit more from a successful market penetration or expansion strategy.

When an MNE enters a new market with its product or expands market share of its product in an existing market through its subsidiary, questions of the creation of marketing intangibles and increases in the value of product-related intangibles such as trademarks, trade names etc. follow closely behind. It is important to examine and follow the process of creation of intangibles in a market, as well as the legal ownership of such intangibles and the right to share in the return from such intangibles (the notion which some countries refer to as "economic ownership"). Transfer pricing aspects of these issues are discussed in greater detail in Chapter 6 on intangibles.

3.5 Further Steps in Comparability Analysis

3.5.1 Selection of the Tested Party

3.5.1.1 When applying the Cost Plus Method (CPM), Resale Price Method (RPM) or Transactional Net Margin Method (TNMM) (see further Chapter 4) it is necessary to choose the party to the transaction for which a financial indicator (mark-up on costs, gross margin or net profit indicator) is tested. The choice of the tested party should be consistent with the functional analysis of the controlled transaction. Attributes of controlled transaction(s) will influence the selection of the tested party (where needed).

3.5.1.2 The tested party normally should be the less complex party to the controlled transaction and should be the party in respect of which the most reliable data for comparing the results of similar independent transactions is available. Either the local or the foreign party may be the tested party. If a taxpayer wishes to select the foreign associated enterprise as the tested party, it must ensure that the necessary relevant information about it and sufficient data on comparables is available to the tax administration in order for the latter to be able to verify the proper selection of the tested party and the accurate application of the transfer pricing method.

3.5.2 Identification of Potentially Comparable Transactions or Companies

3.5.2.1 Comparable uncontrolled transactions ("comparables") are of two types:

- Internal comparables, i.e. transactions between one of the parties to the controlled transaction (taxpayer or foreign associated enterprise) and an independent party; or
- Third-party or external comparables, i.e. comparable uncontrolled transactions between two independent parties, neither of which is a party to the controlled transaction.

Internal Comparables

3.5.2.2 Even though internal comparables may display a higher degree of comparability, there is a need to subject internal comparables to as rigorous a scrutiny as external ones regarding comparability factors, and to make comparability adjustments when necessary. Use of internal comparables may have advantages but also requires caution as mentioned below; accordingly, this will require careful consideration of the facts and circumstances of each case.

3.5.2.3 The advantages of internal comparables are:

- Internal comparables may have a more direct and closer relationship to the transaction under review than external ones due to one party to the transaction being the same. This may make functional comparisons easier and may make it easier to conclude that identical accounting standards are being applied;
- Transaction specific financial and other information is more likely to be available; and
- Comparability analysis involving internal comparables may be less expensive for the taxpayer as no public database search is required.

3.5.2.4 A potential disadvantage of internal comparables is that they may not necessarily be the best evidence if differences exist between the tested transaction and the proposed comparable. For example, differences may exist in transaction volumes, contractual terms, geographical markets and business strategy, which are material and cannot be eliminated through reliable comparability adjustments.

3.5.2.5 Internal comparables, where available and reliable, may allow the taxpayer to consider the use of the CUP Method which is the most direct and reliable method if it can be applied. Internal comparables may also be used with the other recognized transfer pricing methods.

3.5.2.6 However, reliable internal comparables may not exist. If that is the case, it will be necessary to examine external sources of potential comparable transactions among third parties.

Third-party Comparable/External Comparable

3.5.2.7 There are two types of third-party or external comparables. The first type relates to transactions between two independent parties, neither of which is a party to the controlled transaction. For example, it might be possible to apply the CUP Method based on the price of a comparable product sold under comparable circumstances by uncontrolled parties.

3.5.2.8 The second type of external comparable relates to the use of the results of comparable uncontrolled companies (engaged in comparable transactions) when applying profit-based transfer pricing methods. Typically, such results are identified through the use of commercial databases and the application of "screening" criteria. The determination of appropriate screening criteria is a critical step and should be based on the most economically relevant characteristics of the accurately delineated controlled transaction (see section 3.5.2.28 et seq.). The objective of finding the closest comparables must, however, also be balanced with the need to be pragmatic and to find an answer.

Sources of Information for External Comparables

3.5.2.9 There are various sources of data and information which are available to assist a taxpayer or tax administration in identifying potential external comparables. Possible sources range from commercial or electronic databases to regulatory and other government filings and various analytical reports issued by trade and industry associations. The search objective is to identify the most reliable comparables for the controlled transaction under examination according to the specific set of criteria.

3.5.2.10 The data sources provide a vast array of information. Some provide simple leads or contacts, or a starting point to learn more about a particular industry so that appropriate comparables are ultimately selected. Others provide business profiles and detailed financial information about potential comparables. Each source can be important in establishing and documenting the quantitative basis for an arm's length transfer pricing policy.

3.5.2.11 A key resource among the general sources of information is that of commercial databases including databases in electronic form. These databases have been developed by various organizations which compile accounts filed by companies with the relevant administrative bodies and present them in an electronic format suitable for searches and statistical analysis. Some of these databases compile financial data from one country only, while others compile regional or even global data. These products typically provide detailed financial information as well as some textual information such as short business descriptions. The level of detail available in the database largely depends on the country concerned.

3.5.2.12 The advantage of commercial databases is that they can provide the ability to sort quickly and retrieve selectively only the potential comparables that meet certain qualitative and quantitative screening criteria. Criteria commonly used for initial screening include industry codes, scale or sales volume, ownership and related/associated enterprises, availability of financial data or certain financial ratios.

3.5.2.13 It is important to note that commercial databases rely on publicly available information. These databases may not be available in all countries, since not all countries have the same amount of publicly available information about their companies. Further, due to the different disclosure and filing requirements depending on the legal form of the enterprise, the information may not be in a similar format, making it difficult to compare. Most of these databases are used to compare the results of companies rather than of transactions because third-party information at a transactional level is generally not readily available.

3.5.2.14 Commercial databases can be a practical and sometimes cost-effective way of identifying external comparables and may provide the most reliable source of information, depending on the facts and circumstances of the case. However, a number of limitations to commercial databases are frequently identified and commercial databases are not available in all countries. Further, they may be costly to use and many developing countries may not have access to them. The use of commercial databases is not compulsory, and it may be possible to identify reliable comparables from other sources of information, including internal comparables as described above, or a manual identification of third parties (such as competitors) that are regarded as potential sources of comparables for the taxpayer's controlled transaction.

3.5.2.15 In addition to information from commercial databases of company results, a number of other sources of information may be useful, including in some cases, price databases, publications and exchange quoted prices for commodities. Such publications may provide useful information on market conditions and prices of standard commodities. They can also be useful in understanding relevant market dynamics for the products concerned. In some cases, it may be appropriate to use quoted prices from commodities or futures exchanges in order to benchmark transfer prices for commodities (see 4.7. on the application of a separate transfer pricing method relating to transactions in commodities). However, as with any such source of potential benchmarking data, its reliability in pricing the tested transaction must be carefully considered, particularly in the case of information in relation to less transparent markets, i.e. those in which information on individual transactions is not generally available to those who are not a party to the transaction. In such cases, the published information will typically be based on the publisher's observations and contacts with key market participants. While this kind of information can be useful, it should be borne in mind that the publisher may have made adjustments to the raw data in ways that may not be apparent. Such data should therefore be used with care.

Other Sources of Comparable Data

3.5.2.16 Other sources of comparable data may include the following:

- Government sources—many governments and regulatory agencies maintain databases on several industries. Such sources can be located on the agency's Internet websites;
- Trade institutions and organizations—often these institutions or organizations will maintain databases and research reports, and/or hold files with data on potential comparables. Generally, these institutions or organizations would be:
  - Chambers of commerce;
  - Trade and professional organizations;
  - Embassies, consulates or trade missions; or
  - International organizations (e.g. the UN, the OECD, the World Bank Group, and the IMF).
- Other sources of knowledge on competitors or other entities which may make suitable comparables.

Process for Identifying Potential Comparables

3.5.2.17 In identifying potentially comparable uncontrolled transactions or enterprises two approaches are possible: the "additive" and the "deductive".

3.5.2.18 In the additive approach a list is prepared of potentially comparable uncontrolled transactions or of third parties which are believed to be carrying out potentially comparable transactions. As much information as possible on these transactions is then collected to confirm whether they are in effect acceptable comparables, based on the economically relevant characteristics for the controlled transaction. When adopting the additive approach special care should be taken in order to provide a reliable comparable; it is not sufficient that a third-party company be well-known in the relevant industrial sector. Also, one needs to avoid potential third-party companies who themselves have transfer pricing issues.

3.5.2.19 The deductive approach usually commences with a search on a database for comparable companies or transactions. These can be commercial databases developed by editors who compile accounts filed by companies with the relevant governmental authorities, or proprietary databases developed by advisory firms. The approach typically starts with the identification of a wide set of companies that operate in the same sector of activity, perform broadly similar functions, and do not present economic characteristics that are obviously different.

3.5.2.20 It should be emphasized that the exclusive use of either of the two approaches may not yield valuable results. Depending on the facts of each case, one of the above two approaches can be used or both in combination.

3.5.2.21 It is possible that companies identified using the additive approach may not have been identified when using the deductive approach. This may in some cases suggest that the search strategy applied under the deductive approach is not sufficiently robust and should be reassessed, or simply that certain information is not contained in the database selected. Therefore, the additive approach could be useful for assessing whether the deductive search strategy is reliable, comprehensive and appropriate given the economic characteristics being considered.

3.5.2.22 It is very important that the taxpayer or tax administration using the "additive" and/or "deductive" approaches justifies and documents the criteria used to include or exclude particular third-party data from the pool of potential comparables, in order to ensure a reasonable degree of objectivity and transparency in the process. In particular, the process should be reproducible by the taxpayer and by the tax administration that wishes to assess it. It is also very important that third-party data be refined using qualitative criteria. It would be improper to use financial information relating to the transactions of a large sample of companies that have been selected solely because they are classified in a database under a given industry code.

Deductive Approach: Initial Identification and Screening of Comparables

3.5.2.23 After having developed a set of comparability criteria that are tailored to the specifics of the controlled transaction at issue, the next step is to conduct an initial identification and screening of potential independent comparables. The objective in this initial screening, where performed using a commercial database, is to identify substantially all companies that have a reasonable probability of demonstrating the threshold comparability requirements and of providing verifiable, objective documentary evidence of market pricing or profits. In other words, the desired initial result is to obtain the largest possible pool of potential independent comparables for subsequent screening, verification, and analysis. Where comparables are selected from information sources other than databases this part of the process may be different.

3.5.2.24 The process of screening, verification and selection of comparables will largely depend upon the availability of databases in the public domain in the country. Public databases may be available in some countries whereas other countries may not have these databases. In such cases, one of the options could be to rely on a database from a comparable economy with reasonable and reliable adjustments.

3.5.2.25 The following analytical needs and constraints should, however, be kept in mind:

- The search process should avoid any systematic biases;
- The screening process must be executed and documented in a manner consistent with the general requirement for due diligence; and
- It should be recognized that some of the initial comparables will be eliminated in subsequent stages of screening and analysis.

3.5.2.26 The person performing the search for comparables may have to use a variety of information sources for third-party or external comparables. These can include company-specific information sources including annual reports, regulatory and other government filings, product literature and securities analyst reports, as well as various trade and industry association materials. Once intermediate screening has been completed a complete set of company financial statement data should be generated and reviewed for adequacy, period coverage and general consistency. Sometimes details may even be obtained through telephone or personal interviews with company management and it is also possible to use the knowledge of internal operating personnel to identify comparables. For example, sales and marketing personnel can be asked to assist in identifying independent third-party resellers whose financial statements may be used as a basis for establishing comparable profit margins.

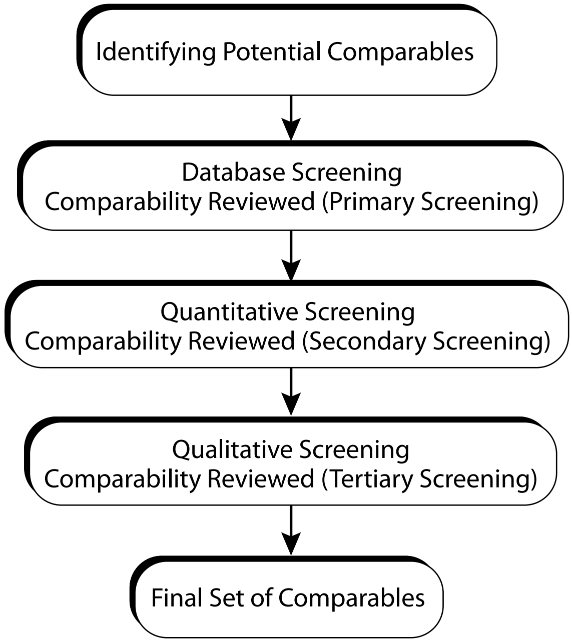
3.5.2.27 Examination of the economically relevant characteristics of the accurately delineated controlled transaction will help in the selection of the most appropriate transfer pricing method and in developing search criteria to identify reliable comparables with which to apply the selected method. This examination is the primary focus of the functional analysis described above in section 3.4.4.

Development of Comparable Search or "Screening" Criteria

3.5.2.28 Comparable search or "screening" criteria are developed based upon the results of the above-mentioned examination of the economically relevant characteristics in relation to the controlled transaction. These criteria must be defined so as to identify those external uncontrolled transactions that satisfy comparability *vis-à-vis* the controlled transaction and the tested party. The search criteria should be set so as to select the most reliable comparables. At the same time, the initial search criteria should not be overly restrictive, in order not to set unrealistic expectations in terms of comparability. Once potential comparables have been selected comparability adjustments should be considered, and in cases where they improve the reliability of the comparison, they should be made. The selection of the most appropriate transfer pricing method will primarily be driven by the nature of the accurately delineated transaction, but of course, the availability of reliable comparables will influence the choice.

3.5.2.29 A typical process of comparable searching may be divided into three screening phases, namely (i) database screening (primary screening), (ii) quantitative screening (secondary screening) and (iii) qualitative screening (tertiary screening). Potential comparables are reviewed in each of these phases to determine whether they qualify as comparables.

Figure 3.D.5
Database Screening (Primary Screening)



3.5.2.30 The determination of appropriate screening criteria will depend on the most economically relevant characteristics of the accurately delineated transaction. Typically, they will begin with the industry code and include screens to ensure the transactions engaged in by the potential comparables are indeed comparable and uncontrolled, and that sufficient financial information is available and can be relied upon. While screens based on industry codes and geographic market are commonly applied, it is always important to consider what characteristics are most economically relevant to the accurately delineated tested transaction(s). For instance, functional comparability may be more important than similarity of industry or market. In such cases, indiscriminate application of the less relevant criteria may be unhelpful, resulting in no comparables being left with which to apply the transfer pricing method.

3.5.2.31 Information derived from external comparables should reflect the economic environment at the time the controlled transaction was undertaken.

In principle, information from external comparables contemporaneous with the controlled transaction might be expected to reflect the same economic environment, but there can be practical difficulties in obtaining contemporaneous information given the time required for such information to be prepared, reported, and uploaded on to databases. For a discussion on timing issues, see section 3.6.2.

3.5.2.32 Examining multiple year data may be useful in a comparability analysis but it is not a systematic requirement. Multiple year data may be used where they add value and make the transfer pricing analysis more reliable. Circumstances that may warrant consideration of data from multiple years include the effect of business cycles in the taxpayer's industry or the effects of life cycles for a particular product or intangible. However, the existence of any such cycle needs to be aptly demonstrated by the taxpayer.

Example of a Typical Process of Database Screening — Reviewing Comparability[25]

The process described in this box is simply an example of a commonly-used approach to conducting a database search for comparables. In any particular case, however, consideration should be given to the most economically significant characteristics of the accurately delineated transaction under review as the basis for determining appropriate screening criteria. For instance, it may be unhelpful to eliminate potential comparables from other markets where geographic or market similarity is not in fact critical to the prices or profits associated with the transaction under review.

1 Industry/business activity qualification codes

A common starting point in the comparables search process is industry/business activity classification codes. Countries may have a set of industry classification codes used for statistical or other purposes. Alternatively, Standard Industry Classification codes (SIC) the Nomenclature of Economic Activities in the European Community (NACE), and the North American Industry Classification System (NAICS) industry codes are the most commonly used by taxpayers and tax administrations worldwide.

This screen will typically also enable a focus on the appropriate level of the market.

25 Ibid. See Box 7, p.43.

2 Geography/region/country/market

It generally makes sense to consider potential comparables from the same geographic market as the tested party in the first instance as this will minimize any potential differences that could have a material effect on the comparison. However, in many countries, especially developing countries, the availability of independent comparables, or of public information on independent comparables, is limited. Where there is no information available relating to transactions that are in other respects comparable to the tested transaction and relate to the same geographic market, it is important to consider the relative importance of the various comparability factors, bearing in mind that the aim is to find the most reliable comparables available. That is, other comparability factors such as those relating to the functional analysis may be more important in a particular case than the geographic market, in which case, this screening criterion could be demoted or even abolished. Where the market is considered to be a key comparability factor, it may be appropriate for this to be defined as a country, a region, or group of countries that are considered to be either (a) a single or largely integrated market; or (b) sufficiently similar to the market of the tested transactions.

3 Key words related to the business activity

This stage generally involves identifying and searching for key terms related to the tested party's business and the activities associated with the transactions under review. For example, key words may relate to the most important activities and the level of market.

4 Availability of financial information

For practical reasons, potential results are screened out if information in relation to the relevant years are missing. In the event that multiple year data is being used, it may be pragmatic to screen out potential results with two or more years of information missing.

5 Level of revenues (or other indicators of size, such as assets or number of employees)

In some cases, the magnitude of the business can have a material effect on comparability. If so, it can be relevant to include a screen based on the size of the potential comparables, as measured by, for instance, turnover, asset values, employees, etc. In addition, it may be appropriate in some cases to examine more carefully any companies with continuous losses. At arm's length, independent companies may make losses, but this would not be expected to continue for an extended period of time.

6 Independence, public vs privately held companies

A fundamental element of the arm's length principle is that of a comparison between the controlled transaction and uncontrolled transactions. Therefore, most search processes will seek to eliminate transactions that have been entered into by entities that belong to a multinational group. However, where no more reliable comparables are available, group members with no or only very limited related party transactions which do not materially affect their gross or net margin may need to be used.

There can be advantages to restricting the search to publicly held companies since disclosure and audit requirements for such companies are typically more rigorous. Public companies are also generally required to provide considerably more detail in their audited financial statements and in the accompanying notes and management review of operations. However, in many cases, whether or not a potential comparable is publicly held is likely to be less important as a comparability factor than other considerations such as functional similarity. Thus, where data are scarce, eliminating potential comparables on this basis may not be pragmatic.

7 Type of financial accounts

This stage focusses on identifying entities that provide either consolidated or statutory financial accounts. Financial information of comparables should not be affected/influenced by connected circumstances. Care must be taken when using consolidated financial accounts. They may be used only if the functions conducted by the consolidated group equate to those of the tested party.

It is also important to ensure potential comparables' financial statements are audited, conform to generally accepted accounting principles (GAAP), have sufficient detail, and are available in a relatively consistent form over time.

8 Active/inactive entities

Inactive entities are usually screened out in the search process as circumstances between active and inactive entities are generally different.

9 Primary screening for functional comparability

This is an important step, which will often need to be continued in the secondary and tertiary screening phases of the process. In some cases, the key word search related to business activities described above can be refined by screening transactions based on certain amounts in the financial accounts which would indicate the existence (or absence) of certain functions or assets. For example, if the tested party does not undertake any research and development and does not use any intangibles which may have been created through R&D, it may be appropriate to include a screen to exclude entities which have non-negligible amounts of R&D expenses. See also the discussion of diagnostic ratios in section 3.5.2.34 et seq.

It may also be possible to screen out those entities engaged in significant business activities that are substantially dissimilar to the controlled transaction and are not adequately disclosed to allow segmentation. Entities engaging in significant non-comparable activities should be excluded from the set of comparables.

Quantitative or Secondary Screening, Verification and Selection

3.5.2.33 The quantitative screening step involves further screening of the financial information relating to the potential comparables for the relevant period to determine whether their activities are comparable to that of the tested party, and whether they report sufficient data at the level needed to apply the selected transfer pricing method. Under this step, the search process focuses on a rigorous review of each transaction or company in the potential independent comparable pool against the full range of specific screening criteria. The objectives at this stage are verification, final screening and selection. This process is based on trial and error and requires multiple data sources, cross-checks and selected follow-up and confirmation of factual data. It will often be difficult to find 'perfect' comparables for a controlled transaction. Therefore, in undertaking the screening process, judgement is required. If the primary screening is applied too rigorously and inflexibly, it may be the case that no apparent comparables remain. In such cases it is particularly important to focus on the most economically significant characteristics of the controlled transaction while dispensing with other, less critical screening criteria for the transaction at hand. Where this is the case, secondary screening can be particularly useful to refine the set of potential comparables.

3.5.2.34 For example, such screening may be done using diagnostic ratios. Diagnostic ratios are financial ratios applied to reject comparables that do not fulfil certain criteria. Particularly in cases where broad primary screening criteria have been used, diagnostic ratios can be used to improve the reliability of a potential set of comparables by helping to distinguish between results from transactions with differing degrees of comparability, and seeking to eliminate those with a lower degree of comparability from the potential comparable set. One or a combination of diagnostic ratios may be used as a kind of additional screen to narrow a range in cases where comparability defects remain in the potential comparables set that are otherwise difficult to eliminate, resulting in a range that would otherwise be overly wide.

3.5.2.35 For example, a ratio of marketing and advertising expenses to sales could be an indicator of the intensity of the marketing and advertising function undertaken. This ratio could then be used to refine the arm's length range based on comparables with similar levels of marketing / advertising intensity in cases where the tested party makes sales to independent customers. Note that it would generally not be reliable to use a diagnostic ratio which comprises elements that are themselves the subject of related party transactions.

3.5.2.36 The application of diagnostic ratios is based on the assumption that a diagnostic ratio reflects a value driver of a particular line of business and is a reflection of the comparable functional and risk profile. In practice, it also depends on data availability. Most countries with transfer pricing rules acknowledge that the application of a net margin method is less sensitive to product and functional similarity than a traditional transaction method. However, functional comparability is still required in practice so a proper functional analysis and a good understanding of the tested business are essential in determining what diagnostic ratios may be useful, and to help avoid "cherry picking" or subjective use. Diagnostic ratios enable some of the features of a potential comparable that are economically relevant for the comparable search process to be taken into account when performing the comparable search.

3.5.2.37 In order to identify potential comparables with a similar functional and risk profile a diagnostic ratio measuring, for example, the level of wage costs compared to an appropriate base (e.g. total operating costs or total turnover) can be used as a yardstick to measure the level of technical manpower employed by comparable companies engaged in software development. The identification of a diagnostic ratio will depend upon several factors such as geographical location; the nature of the business, product and services; the product and service market etc. Using diagnostic ratios may help to identify comparables which are in line with the functional and risk profile of the tested party.

3.5.2.38 The diagnostic ratio is applied by using cut-off criteria. With this method, financials of the tested party are used to calculate the diagnostic ratios and these ratios are then used to create minimum or maximum values to reject companies. Once a cut-off is determined, generally all the values above or below a particular range of the cut-off will be eliminated, depending upon the facts and circumstances of each case. Subsequently, based on the functional and risk profile of the tested party, all companies with a diagnostic ratio above and below the cut-off range will be excluded.

Examples of Diagnostic Ratios

Diagnostic ratios can be a useful additional tool for refining a comparables search. Depending on the facts and circumstances, many different ratios can be envisaged. In determining an appropriate ratio to apply, consideration should be given to what are the most economically significant characteristics of the tested transaction, and how such characteristics might be reflected in the accounts. It should be noted, however, that the ratio should not use amounts that relate to controlled transactions. For example, if an entity makes sales to a related party, it would generally not be reliable to use a sales-based ratio in the screening process.

Some examples of diagnostic ratios are set out below:

- days of inventory (average)
- days receivable (average)
- days payable (average)
- turnover per employee
- fixed assets over total assets
- inventory over sales
- operating assets to total assets
- fixed assets to total sales
- fixed assets to number of employees
- operating expenses to sales
- cost of sales to sales
- inventory to total assets
- research and development expenses to total costs
- advertising and promotion expenses to total costs

Qualitative or Tertiary Screening and Interpretation of the Data

3.5.2.39 The final stage in the comparables search involves manual consideration of each potential comparable (particularly in the case where the results concerned are the gross or net profits of potentially comparable companies, rather than individual pricing data). For instance, this may involve a review of websites and other publicly available information on the shortlist of potentially comparable companies to ensure they are as reliable as possible.

3.5.3 Adjustments to Comparables

3.5.3.1 Certain adjustments may be needed in order to satisfy the requirements for accuracy and reliability of the comparables so that the financial results of the comparables are stated on the same basis as those of the tested party. However, the following important issues should be considered before such a comparability adjustment is made:

- Quality of data being adjusted: a comparability adjustment may be made only where it improves the reliability of comparables. If the search process for comparables has major shortcomings, the addition of unreliable or multiple adjustments will not produce reliable arm's length outcomes;
- Purpose of adjustment performed: adjustments should not be made for differences that have no material effect on prices or margins being tested;
- Not every transaction being compared is capable of being adjusted: there are transactions where reasonably accurate adjustments can be quantified and be made, but in other situations, the accuracy of an adjustment is uncertain and speculative and the adjustment therefore should not be made; and
- Reliability and accuracy of the adjustment: the adjustment should be calculated based on objective and verifiable data.

3.5.3.2 Comparability adjustments are part of the comparability analysis and should be appropriately documented in order to ensure their reliability.

3.5.3.3 Comparability adjustments can be divided into three broad categories:

1. Accounting adjustments;
2. Balance sheet/working capital adjustments; and
3. Other adjustments.

3.5.3.4 Accounting adjustments: There are various types of difference in accounting standards and practices between the tested party and third parties used as comparables which may lead to measurement errors if adjustments are not made. The accounting differences can be grouped under the following categories of classification differences and differences under relevant law or standards.

3.5.3.5 Accounting differences may relate to classification where certain operations are recorded in different accounting lines. For example:

- A sales rebate granted to a customer may result in an adjustment to sales or be recorded as negative sales or marketing expenses depending upon accounting practice, and this may affect gross margins (RPM);
- R&D expenditure may be reflected either in operating expenses or in the cost of sales, thus gross margins are not comparable and this requires appropriate adjustment (CPM); or
- Similarly, the lack of a clear distinction between direct costs and indirect costs affects gross margins. Many of these classification differences are eliminated by applying the TNMM. However, even when using TNMM on a net margin level some accounting differences may exist which can affect net margin in the same way as gross margins resulting in differences between the tested party and comparable. Examples include different depreciation periods, different accounting treatment of employee's stock options etc.

3.5.3.6 Other accounting differences that may warrant adjustments relate to situations where a comparable or tested party may have a choice under relevant law or standards to capitalize or expense certain costs like R&D expenses. Thus, a company may have developed significant intangibles but have no intangible property in its assets on the balance sheet. Similarly, different accounting law or standards may be applicable to goodwill recognition and amortization which may create significant discrepancies between the comparables and the tested party. In many cases it is difficult to identify differences in accounting standards due to the following reasons:

- Limited amount of detail available with regard to comparables in the public domain;
- Potential inconsistencies in the reporting of company financial data by private reporting services;
- Inconsistencies among methods of reporting among companies; and
- Different accounting standards followed in different countries.

3.5.3.7 Balance sheet adjustments are intended to account for different levels of inventories, receivables, payables, interest rates etc. The most common balance sheet adjustments, made to reflect differing levels of accounts receivable, accounts payable and inventory, are known as working capital adjustments. The fact that balance sheet adjustments are found most commonly in practice does not mean that they should be performed on a routine or mandatory basis. A significantly different level of asset intensity may require further investigation of the comparability characteristics of the potential comparable and merely making a working capital adjustment would not alleviate the problem.

3.5.3.8 It is very common for the tested party and each of the potential comparables to differ materially in the amount of working capital (inventory, accounts receivable and payable). Such differences are generally caused by differences in the financing terms of purchases and sales that the company receives from its suppliers and extends to its customers, and by differences in the levels of inventory held by the company. Such differences may generate substantial differences in the working capital structure and may have an impact on the operating profits of the companies due to the financing costs. In order to reduce the effect of differences in terms of purchases and sales and levels of inventory on profitability, adjustments can be made to reflect the time value of the receivables, payables and inventory of the comparables. This, however, should be done only if such adjustments can be reasonably made and they improve comparability.

3.5.3.9 Adjustments for inventory, accounts receivable and accounts payable follow the same basic mechanics. First a value is calculated as the difference between the ratio of the balance sheet item in question to net sales for the comparables and the same ratio for the tested party. The denominator of these fractions will be an arm's length amount for the tested party, for example the denominator of a Profit Level Indicator (PLI) can be used. An alternative approach would be to calculate these ratios with respect to operating expenses such as where gross profit/operating expenses are the PLI used. The resulting difference in the ratios is then multiplied by an interest rate and by the net sales of the comparables to generate an amount to adjust the income statements of the comparables. Then the PLI of that comparable is recomputed.

3.5.3.10 The following example shows how the results of the comparable are adjusted to reflect the tested party's levels of working capital. The other approach could be that calculations are made to adjust the tested party's results to reflect the comparable's levels of working capital or to adjust both the tested party's results and the comparable's results to reflect "zero" working capital. In general, working capital adjustments are calculated for inventory, trade receivables and trade payables. The method for calculating working capital adjustments for all three accounts follows the same basic approach. To begin with, a value is calculated for differences in levels of working capital between the tested party and the comparable party relative to the appropriate base. The appropriate base will be the denominator used for calculating the PLI which can either be costs, sales or assets. The resulting difference in the ratios is then multiplied by an appropriate interest rate. A working capital (WC) adjustment so computed is either adjusted to the PLI of the comparable or to the Tested Party's PLI for the purpose of comparison.

Figure 3.D.6
Working Capital Adjustments

$$\text{Working Capital (WC)} = \frac{\text{Tested Party WC}}{\text{Tested Party PLI}} - \frac{\text{Comparable Party WC}}{\text{Comparable Party PLI}} \times \text{Interest}$$

3.5.3.11 Example of Working Capital Adjustment

Example: Information Technology Company

The following hypothetical illustration is provided merely to demonstrate how a working capital adjustment can be calculated. It should not be construed as the only way in which such an adjustment may be calculated.

Working Capital Adjustment		
Particulars	**Tested Party**	**Comparable Party**
Sales (A)	100	120
Earnings before interest and taxes (EBIT) (B)	5	7
Operating profit margin (PLI) (B/A in %) (C)	5%	5.8%
Accounts receivable (D)	100	110
Inventory (E)	20	40
Accounts payable (F)	50	50
Net working capital (G) (D+E-F)	70	100
Net working capital to sales (G/A in %)	70%	83.3%
Difference between net working capital to sales of tested and comparable party (H)		-13.3%
Interest rate on NWC (I)		5%
Adjustment (J) (I*H)		-0.665%
Working capital adjustment –		
Re-computing the PLI for the comparable (C-J)		5.1%

3.5.3.12 Other adjustments are those proposed by the taxpayer or tax administrator to adjust for specific economic circumstances that affect the transactions being compared. There can be significant differences in the mix of functions performed by the potential comparables *vis-à-vis* the tested party, or in the assets used or contributed, risks assumed or capital employed. When such differences exist and are not adjusted, they may affect the reliability of the comparables in establishing an appropriate arm's length profit range.

3.5.3.13 The financial results of the comparables may need to be adjusted to eliminate the effect of such differences. Such adjustment is possible only when reliable and accurate segmented detailed information is available. An adjustment is made to the revenue and costs relevant to the functions performed by the comparables but not by the tested party. If an arm's length return is established for additional functions performed by the tested party, it is not necessary to adjust the comparables. That arm's length return based on another set of comparables may be applied to the tested party for those functions. Care should be exercised while making a functional adjustment which involves a subjective assessment.

3.5.3.14 There can be significant differences in the mix of functions performed by the potential comparable *vis-à-vis* the tested party. For example, a controlled distribution company may differ from a set of independent distribution companies in that it performs import and regulatory functions not performed by the independent distributors (notwithstanding that the independent distributors have been determined to be the best available comparables); performs only first-tier distribution functions and performs limited manufacturing and assembly functions. To adjust for such differences, the financial results of the comparable may be adjusted to account for the revenue, costs, and associated profits associated with the functions performed by the comparable but not by the tested party, or vice versa.

3.5.3.15 Adjustments performed to compensate for material differences in the mix of functions performed by a controlled storage device distributor and a set of independent storage device distribution comparables is considered here to illustrate this point. It is assumed that the independent device distributors (determined to be the best available comparables) also perform manufacturing/assembly operations and downstream distribution functions that are not performed by the controlled storage device distributor. In this case, the financial results of the comparables may need to be adjusted to eliminate the profits associated with manufacturing/assembly operations and with downstream distribution functions based upon the profitability earned in uncontrolled comparable storage manufacturing and downstream distribution transactions. In other words, for comparability purposes, only the functions comparable to the functions carried out by the controlled storage device distributor should be taken into consideration.

3.5.3.16 To contrast the treatment above with a different set of circumstances, it could be assumed that the controlled storage device distributor above performs some import functions which are not performed by the independent distributors. The margins of those comparables that did not perform import functions could perhaps be adjusted to reflect an arm's length profit associated with these functions if sufficient data exist to make an accurate adjustment.

3.5.3.17 Where a significant part of the potential comparable's profits is attributable to significant, unique intangibles, such as unique product design or unique engineering, that are not present in the tested party, it may not be possible to eliminate the effects of such intangibles on operating profits by performing reliable comparability adjustments. If accurate adjustments cannot be made, the potential comparable may need to be rejected.

3.5.3.18 As suggested earlier, economically significant risk is related to anticipated reward and it would be expected that this would be reflected in a controlled transaction that satisfies the arm's length principle. However, the actual return may or may not increase depending on the degree to which the risk is actually realized. Accordingly, similarity in the level of risk is an important consideration in selecting comparables.

3.5.3.19 The degree of comparability between a tested party and an uncontrolled taxpayer is impaired when the entities assume different economically significant risks which may require making a risk adjustment. For example, a contract manufacturer in certain circumstances may not assume the market risks that fully-fledged manufacturers customarily do and therefore might be expected to earn lower profit margins.

3.5.3.20 There is no universally accepted method for risk adjustment. However, in practice MNEs carry out risk adjustment through the application of certain methods that attempt to quantify on an *ex ante* basis (i.e. before the event) the effect of risk on anticipated profitability based on, for example, the weighted average cost of capital/capital asset pricing model. However, it is worth mentioning that both models are based upon risk models used mainly in relation to the risk of securities. Most statistical methods have their inherent limitations. Therefore, risk adjustment must be made carefully, only where needed and only if a reasonable and accurate adjustment is possible.

3.5.3.21 It has to be recognized that problems can arise due to significant differences in the transactional structure between associated party sales in a controlled company and similar transactions involving independent companies.

3.5.3.22 These problems typically arise in controlled situations when the parties allocate the risks and functions of the enterprise among themselves differently from the allocation of risks and functions between independent enterprises. The differences in the bargaining power and degree of common interest of the associated parties and the independent companies may lead to very different transaction terms, such as extremely long-lived contracts, or instances where transfers of unique intangibles that would not ordinarily be transferred between independent companies are undertaken between the associated enterprises.

3.5.3.23 In some cases material differences may exist in the way transactions are structured by potential comparables and by the tested party, due to the fact that the latter operates with associated enterprises in an MNE. In such cases it may not be possible to find comparable transactions that have the same transactional structure as the controlled transaction. In these circumstances, adjustments may be needed to eliminate the effects of these differences. For example, the margins of independent distributors operating on short-term contracts may not be comparable to those of associated enterprises on long-term contracts, unless an adjustment is made to account for the short duration of the former.

3.5.3.24 It has to be stressed that comparability adjustments should be considered if and only if they are expected to increase the reliability of the results. Relevant considerations in this regard include the materiality of the differences for which an adjustment is being considered, the quality of the data used in the adjustment, the purpose of the adjustment and the reliability of the approach used to make the adjustment.

3.5.3.25 Comparability adjustments are only appropriate for differences that have a material effect on the comparison. A comparison may be appropriate despite an unadjusted difference, provided that the difference does not have a material effect on the reliability of the comparison.

3.5.3.26 No specific rules or guidelines can be given that may be applicable to every transaction. In each case, the critical factors that have a material impact on the price of the product (if the CUP Method is used) or on profit (if the RPM, CPM, TNMM or PSM is used) should be identified. Ultimately, decisions regarding whether adjustments are required depend entirely on the facts and circumstances surrounding the transactions, on the availability of information needed for the analysis and on the accuracy and reliability of any adjustments that may be made.

3.5.3.27 Available information is often not complete enough to enable a review to be made of each possible comparability factor. The analysis almost always takes place with imperfect information. That realization can be helpful in deciding whether a particular difference is material enough to make adjustments, or whether the comparability difficulties should affect the selection of the most appropriate method.

3.5.4 Selection of the Most Appropriate Transfer Pricing Method

3.5.4.1 See Chapter 4 for an explanation of transfer pricing methods and selection of a suitable method.

3.5.5 Interpreting the Data to Determine the Arm's Length Price or Range

3.5.5.1 A comparability analysis may result in an "arm's length range" of financial indicators (prices or margins), all of which may considered to be equally reliable. It should be noted that the domestic law in some countries will specify how such a range is to be derived from the final results of the comparables, for instance by the use of particular statistical techniques. Where the transfer price is within this range, it is normally accepted as arm's length.

3.5.5.2 However, it may be difficult to determine whether the search process has indeed resulted in a range of results, all of which are equally reliable. Uncertainty may also arise in cases where the range of results from a comparables search is very wide. Where such concerns exist therefore, it can be helpful to consider whether it is possible objectively to determine whether some potential comparables are more reliable than others. The (further) use of diagnostic ratios and qualitative screening can sometimes be helpful in this regard.

3.5.5.3 The search for reliable comparables is at the heart of most transfer pricing analyses. In many cases, it may not be straightforward, but rather, require the application of judgement. Care should thus be taken to consider potential screening criteria as objectively as possible, and avoid "cherry-picking" data. Similarly, absent factual changes, it would be expected that such criteria would be used consistently over time.

3.5.6 Analyzing Comparability Data and Determining an Arm's Length Price

3.5.6.1 The degree of comparability between the controlled and the uncontrolled transactions, including the reliability of comparability adjustments needed and the availability of reliable information (especially on uncontrolled comparables) are key factors in selection of the most appropriate transfer pricing method. Other factors include the strengths and weaknesses of the method, the appropriateness of the method in the light of the nature of the controlled transaction (based upon a functional analysis) etc. See further Chapter 4, Methods.

3.5.6.2 Once the transfer pricing method is selected, the next step is to apply the selected method to arrive at the correct arm's length price or profit (or range of prices or profits) and to document the results of the analysis. The topics mentioned in this section are discussed in greater detail in Chapter 4 and 12.

3.6 Further Issues Regarding Comparability Analysis

3.6.1 General

3.6.1.1 The comparability analysis should be as reliable as possible. However, on many occasions a careful comparability analysis will not yield perfect matches in terms of comparable enterprises or comparable transactions to those carried out by the associated enterprises. The nature, type, quality etc. and number of comparables along with the adjustments made during a comparability analysis may be the subject of debate, interpretation and contention between the taxpayer and tax authorities. Some of the key concerns surrounding comparability analysis are described below.

3.6.2 Timing Issues

3.6.2.1 There are timing issues in comparability with respect to the time of origin, collection and production of information on comparability factors and comparable uncontrolled transactions that are used in a comparability analysis.

3.6.2.2 Timing of origin of the transactions needs to be considered. In principle, information relating to the conditions of comparable uncontrolled transactions undertaken or carried out during the same period of time as the controlled transaction ("contemporaneous uncontrolled transactions") is expected to be the most reliable information to use in a comparability analysis, because it reflects how independent parties have behaved in an economic environment that is the same as the economic environment of the taxpayer's controlled transaction.

3.6.2.3 Timing of collection of the relevant comparable data is also a potential issue. In some cases, taxpayers implement transfer pricing documentation to demonstrate that they have made reasonable efforts to comply with the arm's length principle at the time their intragroup transactions were undertaken, i.e. on an ex ante basis (hereinafter "the arm's length price-setting" approach), based on information that was reasonably available to them at that point. Such information includes not only information on comparable transactions from previous years, but also information on economic and market changes that may have occurred between those previous years and the year of the controlled transaction. In effect, independent parties in comparable circumstances would not base their pricing decision on historical data alone. This ex ante analysis of the arm's length price is, however, not the most common approach.

3.6.2.4 In other instances, taxpayers might test the outcome of their controlled transactions to demonstrate that the conditions of these transactions were consistent with the arm's length principle, i.e. on an *ex post* basis (hereinafter "the arm's length outcome testing" approach). This test typically takes place as part of the process for establishing the tax return at the year-end. An ex post (after the event) analysis is the most commonly used method to test the arm's length price of international transactions.

3.6.2.5 The arm's length price setting and the arm's length outcome testing approaches, as well as combinations of these two approaches, are found among countries that have implemented transfer pricing rules. Country views differ as to whether data on contemporaneous transactions which only become available to the taxpayer and tax administration at the time of filing of the tax return, or conducting ex post analysis of transfer pricing, is permitted or represents improper use of hindsight.

3.6.2.6 Another potential question is whether and how to take into account future events in the transfer pricing analysis. Such events were not predictable at the time of the testing of a controlled transaction, in particular where valuation at that time was highly uncertain. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.

3.6.2.7 The main issue is to:

- ➢ Determine whether the valuation was sufficiently uncertain at the outset that the parties at arm's length would have required a price adjustment mechanism; or

- Whether because the change in value was so fundamental, or other developments arose, this would have led to a re-negotiation of the transaction.

Where this is the case, the tax administration would be justified in determining the arm's length price for the transaction on the basis of the adjustment clause or re-negotiation that would be provided at arm's length in a comparable uncontrolled transaction. In other circumstances, where there is no reason to consider that the valuation was sufficiently uncertain at the outset that the parties would have required a price adjustment clause or would have renegotiated the terms of the agreement, there is no reason for tax administrations to make such an adjustment as it would represent an inappropriate use of hindsight. The mere existence of uncertainty should not require an ex post adjustment without consideration of what independent enterprises would have done or agreed between them.

3.6.2.8 Data from years following the year of the transaction may also sometimes be relevant to the analysis of transfer prices, but care must be taken to avoid the use of hindsight, perceiving the significance of facts and events with the benefit of knowledge accruing after they have occurred.

3.6.3 Lack of Reliable Comparables

3.6.3.1 One of the most frequent problems taxpayers and administrations face with comparability analysis is the lack of reliable comparables with respect to the transaction(s). This issue can be particularly acute in developing countries. Issues relating to lack of reliable comparables are discussed above and in the PCT Transfer Pricing Toolkit (see 2.5.3.2).

3.6.3.2 When products, property or services are offered by first-movers in specific segments there may be a dearth of comparables. These transactions typically involve use of new technology, cutting-edge research, bundled intangibles etc. which may not have satisfactory comparables. An example is intellectual property content relating to high-tech computer software. Such situations may be dealt with either by using a one-sided method (CPM, RPM or TNMM) for which the tested party is the one that does not contribute such intangibles; or, in those cases where unique intangibles are contributed by both parties to the transaction, by using a profit split method.

3.6.3.3 Owing to business consolidation and vertical integration, it may be extremely difficult in some industries to find reliable internal or external comparables. An example is the pharmaceutical industry where there exists a high level of vertical integration and consolidation in order to drive up efficiencies. In such scenarios the controlled transactions are part of a larger global supply-chain and it can be difficult to find comparable transactions between independent enterprises. In such cases also, it may be possible under certain circumstances to use comparables from other industries, possibly adjusted, in order to address this issue.

3.6.4 "Cherry-picking" of Comparables / Losses

3.6.4.1 It is frequently not possible to obtain information on perfect comparables in practice, and it is therefore often necessary to use broad search criteria when identifying third-party comparables. It must be ensured that potentially relevant external comparables are not excluded because of "cherry picking" of favourable third-party information by either the taxpayers or the tax authorities, ignoring other information that does not support the position argued for.

3.6.4.2 For example, extreme results may be rejected as comparables after careful consideration by the tax authorities as they tend to skew the data. While this could be a correct application of the arm's length principle in certain circumstances, in other cases the reasons for the extreme result may be genuine and may not always justify rejecting the company from the pool of comparables.

3.6.4.3 The need for careful consideration can be particularly important for a comparable company that loses money in a given year. This may occur because of a recession year which hit the controlled and uncontrolled transactions in the same way, but the loss may also be attributable to unique factors with the potentially comparable company which may warrant a conclusion that strict comparability standards are not satisfied.

3.6.4.4 To come to a correct conclusion, an unbiased analysis of the facts and circumstances surrounding the transactions should be carried out. Where one or more of the potential comparables is loss-making, further examination would be needed to understand the reasons for such losses and confirm whether the loss-making transaction or company is a reliable comparable.

3.6.4.5 Well-documented search procedures and comparability criteria make the application of the comparability standard transparent, in that the comparability standard that was applied is clearly stated and its scope can be evaluated. This will ensure that results are less susceptible to "cherry picking" since the reasons for rejection of each potential comparable are provided.

3.6.5 Intentional Set-offs

3.6.5.1 A deliberate or intentional set-off occurs when an associated enterprise has provided a benefit to another associated enterprise within the MNE group and is compensated in return by that other enterprise with some other benefits. These enterprises may claim that the benefit each has received should be set-off against the benefit each provided and that only the net gain or loss if any on the transactions needs to be considered for tax assessment.

3.6.5.2 Set-offs can be quite complex. They might involve a series of transactions and not just a single transaction or they may involve several members of the MNE group. Ideally the parties identify and disclose all set-offs accurately and have enough documentation to substantiate their set-off claims so that after taking account of these the conditions governing the transactions are consistent with the arm's length principle.

3.6.5.3 The tax authorities may evaluate the transactions separately to determine whether the transactions satisfy the arm's length principle. However, the tax authorities may also choose to evaluate the set-off transactions together, in which case comparables have to be carefully selected. Set-offs in international transactions and in domestic transactions may not be easily comparable due, for example, to the asymmetries in the tax treatment of the set-offs under the taxation systems of different countries.

3.6.6 Use of Customs Valuations

3.6.6.1 The price paid or payable for the goods (which under certain limited circumstances may also include the costs of services and royalties) in import transactions is the starting point for determination of any applicable customs duties. A higher price on import reduces the profit of the importer (all other things being equal) and thus the direct tax that might be due in the importing country. However, where customs duties apply, this would also result in higher duties being payable. Accordingly, there may be an inherent conflict between the revenue implications and the motivation of the customs and direct tax authorities. While the direct tax authority would focus on overvalued import prices, the customs authority will seek to ensure that the declared customs value has not been undervalued to reduce duty liability.

3.6.6.2 The WTO Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 ("the WTO Valuation Agreement") sets out the methodology for determining the customs value of imported goods. Customs valuation is the procedure applied to determine the customs value of imported goods for the purpose of calculating ad valorem customs duties. Article 22 of the WTO Valuation Agreement requires that each Member of the WTO shall ensure the conformity of its laws, regulations and administrative procedures with the provisions of the Agreement. In contrast, for direct tax purposes, the tax authorities in most countries use the "arm's length principle" as a standard for valuing cross-border related party transactions.

3.6.6.3 Both customs valuation and transfer pricing approaches aim at determining an appropriate price for cross-border transactions. However, the approaches differ and in some cases may be incompatible due to different motivations, theoretical frameworks, documentation requirements or other factors, causing practical difficulties for importers. Therefore, better coordination and exchange of information between direct tax and customs authorities is encouraged. However, the extent to which this is possible may depend on how the customs services and tax administrations are organized in each country. For some countries the two organizations are more integrated, and for others they are completely separate.

3.6.6.4 In appropriate circumstances the verified customs value may be useful to tax administrations in evaluating the arm's length character of the transfer prices of imported goods in international transactions between associated enterprises. In particular, customs may have contemporaneous information regarding the transaction that could be relevant for transfer pricing purposes, while tax authorities may have transfer pricing documentation which provides detailed information on the circumstances of the transaction.

3.6.6.5 Some customs administrations are now also making use of transfer pricing data, where relevant, to ensure that the price of an associated party transaction has not been affected by the special relationship between the parties.

3.6.6.6 There are similarities between customs valuation and transfer pricing methods, for instance, one method permitted for the purposes of verifying customs values uses a comparison between the value of the goods imported by a related party with the value of identical or similar goods imported by independent parties, which may be considered as analogous to the application of a CUP Method for transfer pricing. Examining customs values may thus provide relevant information and a useful starting point for transfer pricing purposes in some cases and may also help in reducing the compliance burden for taxpayers. However, it should be borne in mind that customs valuation methods are highly prescriptive and may not be fully aligned with the arm's length principle as it applies for direct tax purposes.

3.6.6.7 There has been a great deal of focus internationally on the interplay between transfer pricing and customs valuation methods. Following two joint World Customs Organization (WCO) – OECD conferences in 2006 and 2007, it became clear that harmonization of the two systems was not a realistic proposition; particularly given the fact that the WTO Valuation Agreement is not expected to be updated in the short to medium term. Discussions have therefore focused on the extent to which Customs may use transfer pricing information when carrying out examination of related party transactions. The principle of the customs valuation in cases involving related party exporters and importers and where there are doubts as to the reliability of the price paid or payable for the goods, is to judge whether the special relationship between the parties influenced the price by examining "the circumstances surrounding the sale" (WTO Valuation Agreement Article 1, paragraph 2(a)).

3.6.6.8 The WCO's Technical Committee on Customs Valuation, which has the mandate for ensuring, at the technical level, uniformity in interpretation and application of the WTO Valuation Agreement, has issued several instruments on this topic.[26] These are briefly summarized below.

3.6.6.9 Commentary 23.1 recognizes the principle that a transfer pricing study may, in some cases, be used by customs as a basis for examining the circumstances of the sale. Following this general principle, Case Study 14.1, sets out a scenario where customs use transfer pricing documentation, based on the TNMM, to confirm that the prices applicable in a related party transaction have not been influenced by the relationship between those parties.

3.6.6.10 Case Study 14.2 also provides an example of customs authorities making use of transfer pricing information (based on the RPM) but in contrast concludes that the declared import price was not settled in a manner consistent with normal pricing practices of the industry but rather had been influenced by the relationship between the buyer and seller.

3.6.6.11 The WCO has produced the WCO Guide to Customs Valuation and Transfer Pricing (2018) mentioned in 3.6.6.8 above, which includes all relevant technical information on the two methodologies and explores the interaction between them. It includes good practices for customs and tax administrations, and businesses. In particular, customs and tax

[26] WCO (2018). *Guide to Customs Valuation and Transfer Pricing.* Brussels: WCO. Available from http://www.wcoomd.org/-/media/wco/public/global/pdf/topics/key-issues/revenue-package/wco-guide-to-customs-valuation-and-transfer-pricing.pdf?la=en. Annex III, VI and VII.

administrations are encouraged to work more closely together and the guide emphasizes that businesses should consider customs' needs when developing transfer pricing strategies. To this end, the WCO has produced Guidelines for Strengthening Cooperation and the Exchanging of Information between Customs and Tax Authorities at the National Level (October 2016).[27] These Guidelines endeavour to provide guidance and ideas to customs and tax authorities for formalizing the contacts and strengthening the existing cooperation at the national level, on a range of issues of mutual interest.

3.6.7 Use of Secret Comparables

3.6.7.1 Concern is often expressed by taxpayers, especially MNEs, over aspects of data collection by tax authorities and its confidentiality. Tax authorities have access to, as they need to, very sensitive and highly confidential information about taxpayers, such as data relating to margins, profitability and business contracts. Confidence in the tax system means that this information needs to be treated carefully, especially as it may reveal sensitive business information about that taxpayer's profitability, business strategies and so forth.

3.6.7.2 A secret comparable generally refers to the use of information or data about a taxpayer by the tax authorities to form the basis of transfer pricing scrutiny of another taxpayer. The taxpayer under scrutiny is not given access to that information — it may, for example, reveal confidential information about a competitor (i.e. the first taxpayer — to which the data relates).

3.6.7.3 There is a need to exercise caution against the use of secret comparables unless the tax administration is able, within the limits of its domestic confidentiality requirements, to disclose the data to the taxpayer whose transactions are being reviewed. This would enable an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts. Taxpayers contend that the use of such secret information is against the basic principles of equity, as the taxpayer is required to benchmark its controlled transactions with comparables not available to it, without the opportunity to question comparability or argue that adjustments are needed. Taxpayers contend that it would be unfair if they face the consequences of adjustments made on this basis, such as additions to income,

[27] WCO (2016). *Guidelines for Strengthening Cooperation and the Exchanging of Information Between Customs and Tax Authorities at the National Level.* Brussels: WCO. Available from http://www.wcoomd.org/~/media/wco/public/global/pdf/topics/facilitation/instruments-and-tools/tools/customs-tax-cooperation/customs_tax_guidelines_en_final2.pdf?db=web

typically coupled with interest, penalties etc. Furthermore, double taxation may not be relieved if secret comparables cannot be disclosed to the competent authority of another country.

3.6.8 Overall Process Complexity

3.6.8.1 Comparability analysis looks simple in theory but in practice it can be a laborious, difficult, time-consuming and, more often than not, expensive exercise. Seeking information, analyzing all the data from various sources, documenting the analysis and substantiating adjustments are all steps that require time and money. It is therefore important to put the need for comparability analyses in perspective. The aim should be to ensure that the compliance burden and costs borne by a taxpayer to identify possible comparables and obtain detailed information thereon are reasonable and proportionate to the complexity of the transaction. It is recognized that the cost of obtaining information can be a real concern, especially for small to medium-sized operations, but also for those MNEs that deal with a very large number of controlled transactions in many countries. However, it should be observed that the burden of cost cannot be a reason for the dilution of comparability standards.

3.6.8.2 These resource considerations apply at least as much to many developing countries, and efforts must be made to ensure that their position is not prejudiced by a lack of such resources in ensuring the arm's length pricing of transactions in their jurisdictions.

3.6.8.3 When undertaking comparability analysis there is no requirement for an exhaustive search of all possible relevant sources of information. Taxpayers and tax administrations should exercise judgment to determine whether particular comparables are reliable.

3.7 Conclusion

3.7.1 Transfer pricing theory meets practice in comparability analysis — the translation of the arm's length principle into the selection of reliable comparables and of the appropriate transfer pricing method, eventually yielding the transfer price. This is all facilitated by comparability analysis.

3.7.2 A good comparability analysis is an essential step in any transfer pricing analysis in order to gain a correct understanding of the economically significant characteristics of the controlled transaction, and of the respective roles of the parties to the controlled transaction. This will assist in the selection of the most appropriate transfer pricing method in the circumstances of the case. This part of the process is fact-based and requires the taxpayer or tax administration to demonstrate an understanding of how business operates.

3.7.3 In most cases, the application of the selected transfer pricing method will then rely on the identification of uncontrolled comparable transactions. This part of the process may be particularly complicated, especially in countries that have limited access to information on potential comparables. It is worth emphasizing that solutions exist to deal with this problem, including the collection of information on internal comparables (i.e. transactions between the taxpayer or its associated enterprise and a third party) where they exist; the collection of public information on third parties (e.g. competitors) that are likely to be involved in uncontrolled transactions comparable to the taxpayer's controlled transaction, or the possible use of databases from other countries.

3.7.4 It is clear that the comparability analysis should be as reliable as possible so as to arrive at the correct arm's length price or profit (or range of prices or profits). In performing this comparability analysis, it may be necessary for the taxpayer or the tax authorities to undertake a detailed functional analysis taking into consideration a wide variety of data sources, other factors and, if necessary, a series of comparability adjustments while arriving at a suitable set of benchmarks (or comparables). The choices made in the course of this analysis have to be substantiated and the overall process has to be thoroughly documented.

3.7.5 It is essential to put the need for comparability analyses into perspective given the extent of the compliance burden and costs that can arise to a taxpayer or tax administration in identifying possible comparables and obtaining detailed information. Taxpayers and tax administrations should exercise judgment to determine whether particular comparables are reliable.

3.7.6 Further, as noted in the introduction, the lack of comparables for a given controlled transaction does not mean that it is or is not at arm's length or that the arm's length principle cannot be applied. This is especially important given the growing importance of integrated business models and of transactions involving unique intangibles for which comparables may not be available. The need for a reliable analysis must therefore be balanced with a pragmatic approach and one should not set unrealistic expectations for comparability analyses.

4 Methods

4.1 Introduction to Transfer Pricing Methods

4.1.1 This Chapter describes several transfer pricing methods that can be used to determine an arm's length price and describes how to apply these methods in practice. Transfer pricing methods (or "methodologies") are used to calculate or test the arm's length nature of prices or profits. Transfer pricing methods are ways of establishing arm's length prices or profits for transactions between associated enterprises. As described in Chapter 3 on Comparability Analysis, the transaction between related enterprises for which an arm's length price is to be established is referred to as the "controlled transaction". The selected transfer pricing method is the mechanism by which the prices or results of the controlled transaction are compared to the prices or results of comparable uncontrolled transactions. In this way, the application of transfer pricing methods helps assure that transactions conform to the arm's length standard. It is important to note that although the term "profit margin" is used, companies may also have legitimate reasons to report losses at arm's length. Furthermore, transfer pricing methods are not determinative in and of themselves. If an associated enterprise reports an arm's length amount of income, without the explicit use of one of the recognized transfer pricing methods, this does not mean that its pricing should automatically be regarded as not being at arm's length and that adjustments should be imposed.

4.1.2 Selection of Methods (How, Why and Use of Methods)

4.1.2.1 In each case, the objective is to identify the most appropriate method for the particular case. Considerations involved in selecting a method can include: the respective strengths and weaknesses of each method; the nature of the controlled transaction; the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method; and the degree of comparability between the controlled and uncontrolled transactions.

4.1.2.2 Method selection is an important part of the comparability analysis described in Chapter 3. The starting point in selecting a method is to develop an understanding of the controlled transaction (inbound or outbound), by means of the functional analysis. The functional analysis establishes the foundation necessary to select the most appropriate transfer pricing method as it helps:

- To identify and accurately delineate the intragroup transactions (the wording "accurate delineation" connotes the act of establishing the facts of the transaction based on available evidence, including the relevant acts of the parties);
- To identify the characteristics that would make a particular uncontrolled transaction or function suitable for use as a comparable;
- To determine any necessary adjustments to the comparables;
- To check the relative reliability of the transfer pricing method selected; and
- Over time, to determine if modification of the transfer pricing method is appropriate because the controlled transaction, function, allocation of risks or allocation of assets have been modified.

4.1.2.3 The major components of a functional analysis are analyses of the functions undertaken by each of the parties to the transaction, together with the assets they use or contribute and the risks they assume. The functional analysis is described and discussed in detail in Chapter 3, at 3.4.4. A summary is provided below for context in the case of selection of appropriate methods.

4.1.2.4 The functions performed: The functional analysis identifies and describes the activities performed by each of the relevant parties such as product design, purchasing, inbound logistics, manufacturing, research and development (R&D), assembling, inventory management, outbound logistics, marketing and sales activities, after sale services, supporting activities, services, advertising, financing and management etc. The functional analysis must specify which party performs each activity and the intensity with which each party performs that function. Where both parties are involved in performing an activity the functional analysis should identify the relevant differences; e.g. if both have inventories but Company A holds inventories for a period of up to two years whereas Company B holds inventories for a period of one month the functional analysis should identify that fact. The activities that add most value must be identified and should be discussed in more detail.

4.1.2.5 The risks assumed: The functional analysis should identify risks assumed and undertaken by each of the parties. Examples are: financial risk (currency, interest rate, funding risks etc.) credit and collection risk (trading credit risk, commercial credit risk), operational risk (systems failure risk), commodity price risk, inventory risk and carrying costs, R&D risk, environmental and other regulatory risks, market risk (country political risk, reliability of customers, fluctuation in demand and prices) and product risk (product liability risk, warranty risk and costs, contract enforceability and the risk of product obsolescence). The party which assumes a risk would expect to have higher earnings than one that does not; and will incur the expenses and perhaps related loss if and when risk materializes.

4.1.2.6 The assets used or contributed: The functional analysis must identify the assets used or contributed by each of the parties and should distinguish between tangible and intangible assets. Tangible assets such as property, plant and equipment have to be financed and an investment in such capital assets would usually be expected to earn a long-term return based on the use and risk level of the investment. Intangible assets are very important as substantial competitive advantage is often achieved by the creation and use of intangible assets. Some intangibles have legal protection (e.g. patents, trademarks, trade names) but other intangibles with less legal protection may be equally important and valuable (e.g. know-how, trade secrets, marketing intangibles etc.).[28]

4.1.2.7 Interplay of the above factors: Today, in an MNE, operations tend to be more integrated across jurisdictional boundaries and the functions, risks and assets are often shared between entities in different jurisdictions. This makes functional analyses both more difficult and more necessary. The functional analysis can help identify which functions, risks and assets are attributable to the various related parties. For example, the functional analysis may reveal that one company performs one particular function but the cost of this is borne by the other party to the transaction. The functional analysis could highlight that situation and consider the legal allocation of risk and the economic substance of the transaction. Another example would be where a company performs one particular function and bears the cost thereof but the benefit also accrues to the other party to the transaction. The functional analysis could emphasize that situation and consider which party bears the risk in legal terms and which party assumes the risk according to the economic substance of the transaction. The functional analysis typically includes a discussion of the industry in which the tested party operates, the contractual terms of the transaction at issue, the economic circumstances of the parties and the business strategies they employ. The functional analysis

[28] See Glossary for a definition of "marketing intangibles"; a term also used extensively in the OECD Transfer Pricing Guidelines.

helps to identify the operations that would be expected to benefit a related party and require an arm's length return.

4.1.2.8 Selecting a method after the functional analysis: Once the functional analysis is performed the application of a transfer pricing method, with the associated evaluation of comparable transactions, may be considered. Transfer pricing methods typically use information on comparables; the lack of such comparables can make a particular method — even one that might seem initially preferred — inapplicable, and a different method more reliable. These comparable transactions are also referred to as "uncontrolled transactions" because the parties involved in the transactions are independent of each other. Although uncontrolled transactions of independent unrelated companies are usually used as comparables for transfer pricing purposes, in practice it is sometimes not possible to identify reliable, closely comparable data in the same markets. In such cases practical solutions should be sought in good faith by taxpayers and the tax administration. Comparability issues are discussed in more detail at Chapter 3.

4.1.2.9 Solutions for cases where comparables are difficult to find may include the following:

- Searching for comparables in other industries where such comparable companies have similar functions, assets and risks;
- Searching for comparables in other geographical regions that share certain key similarities with the country in which a company conducts its business; and
- Using industry analyses (publicly available or conducted internally by the company) to identify profit levels that can reasonably be expected for various routine functions (e.g. production, services, distribution).

The suggestions above are not intended to be exhaustive, neither is any preference implied by the ordering of the alternatives. Rather, the approaches above are presented as examples of what might be done and are included for information purposes only. Due to the difficulty in obtaining access to (publicly available) data, in certain instances methods other than the ones presented above may need to be used. Further guidance on this issue can be found in the PCT Transfer Pricing Toolkit (see 2.5.3.2).

4.1.2.10 Intangibles: Among the factors to be considered in selecting the most appropriate method in the circumstances of the case. It is important to determine which party has developed or acquired any intangibles used and in what capacity, which party has the legal ownership and which party receives the benefit of the intangibles. The party that developed the intangibles and bore the related intangible development risks should be able to obtain benefits from those intangibles for example through:

- A sale or licensing of the intangibles to another party who exploits it; or
- Exploiting the intangible itself, for example by way of an increase in the price of products or services that make use of such intangibles.[29]

4.1.3 Choice of Available Methods

4.1.3.1 There are two general categories of methods. "Traditional Transaction Methods" consist of the Comparable Uncontrolled Price (CUP), the Cost Plus Method (CPM) and the Resale Price Method (RPM). The "Transactional Profit Methods" consist of the Transactional Net Margin Method (TNMM) and the Transactional Profit Split Method (PSM). A number of jurisdictions also apply "other methods" which are considered to provide arm's length results; however, it needs to be ensured that such methods are properly applied to be consistent with the arm's length principle.

4.1.3.2 No preference for particular methods is advocated in this Manual. The most suitable method should be chosen taking into consideration the facts and circumstances. The taxpayer should e.g. take into account the type of transaction, the functional analysis, comparability factors, availability of comparable transactions and the possibility of making adjustments to the data to improve comparability. For further discussion on this issue, see Chapter 3.

4.1.3.3 Once a method is chosen and applied, taxpayers are generally expected to apply the method in a consistent fashion. Assuming that an appropriate transfer pricing method is being applied, a change in the method is typically required only if there are any relevant changes in the facts, functionalities or availability of data.

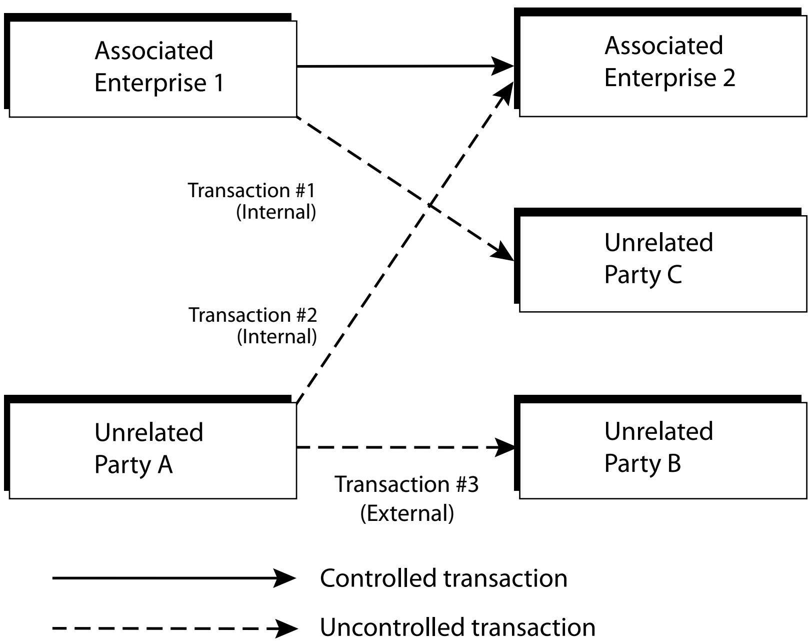
[29] See Chapter 6 on Intangibles.

4.2 Traditional Transaction Methods: Comparable Uncontrolled Price (CUP) Method

4.2.1 Introduction to the CUP Method

4.2.1.1 The Comparable Uncontrolled Price (CUP) Method compares the price charged 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. The CUP Method may also sometimes be used to determine the arm's length royalty rate for the use of an intangible, or to determine an arm's length rate of interest on a loan. CUPs may be based on either "internal" comparable transactions or on "external" comparable transactions. Figure 4.D.1 below explains this distinction in the context of a particular case study.

Figure 4.D.1
Comparable Uncontrolled Price (CUP) Method



4.2.1.2 Facts of the Case Study: The controlled transaction in this figure involves the sale of bicycles between Associated Enterprise 1, a bicycle manufacturer in Country 1, and Associated Enterprise 2, a bicycle importer in Country 2, which purchases, imports and resells the bicycles to unrelated bicycle dealers in Country 2. Associated Enterprise 1 is the parent company of Associated Enterprise 2.

4.2.1.3 In applying the CUP Method to determine whether the price charged for bicycles sold in this controlled transaction is at arm's length, the following information is assumed to be available for consideration:

- The price charged for bicycles sold in a comparable uncontrolled transaction between Associated Enterprise 1 and Unrelated Party C (i.e. transaction #1);
- The price charged for bicycles sold in a comparable uncontrolled transaction between Associated Enterprise 2 and Unrelated Party A (i.e. transaction #2); and
- The price paid for bicycles sold in a comparable uncontrolled transaction between Unrelated Party A and Unrelated Party B (i.e. transaction #3).

4.2.1.4 Comparable uncontrolled transactions, such as transaction #1 or #2, which involve a transaction between the tested party and an uncontrolled party, are referred to as internal comparables. Comparable uncontrolled transactions such as transaction #3, which involves a transaction between two parties neither of which is an associated enterprise, are called external comparables. The application of the CUP Method involves a detailed transactional comparison whereby the controlled and uncontrolled transactions are compared based on the five comparability factors mentioned in Chapter 3.

4.2.2 Comparability in Application of the Comparable Uncontrolled Price (CUP) Method

4.2.2.1 When applying the CUP Method, an uncontrolled transaction is considered comparable to a controlled transaction if:

- There are no differences in the transactions being compared that would materially affect the price; or
- Reasonably accurate adjustments can be performed to account for material differences between the controlled and the uncontrolled transaction.

4.2.2.2 In performing the comparability analysis, the controlled transactions and uncontrolled transactions should be compared based on the comparability factors mentioned earlier and stated in detail in Chapter 3.

In determining the degree of comparability between the controlled transactions and uncontrolled transaction #1 in Figure 4.D.1, for example, the following factors should be taken into account: (i) characteristics of goods being transferred or services provided, (ii) contractual terms, (iii) economic circumstances and (iv) business strategies. For the functional analysis it is necessary to analyze the functions performed, the risks assumed and the assets used or contributed.

4.2.2.3 Product comparability should be closely examined in applying the CUP Method. A price may be materially influenced by differences between the goods sold or services rendered in the controlled and uncontrolled transactions. The CUP Method is appropriate especially in cases where an independent enterprise buys or sells products that are identical or very similar to those sold in the controlled transaction or in situations where services are rendered that are identical or very similar to those rendered in the controlled transaction.

4.2.2.4 Although product comparability is important in applying the CUP Method, the other comparability factors should not be disregarded. Contractual terms and economic conditions are also important comparability factors. Where there are differences between controlled and uncontrolled transactions, adjustments should be made to enhance reliability.

4.2.2.5 Reasonably accurate adjustments may be possible for differences in:

- ➢ The type and quality of the products. E.g. unbranded Kenyan coffee beans as compared with unbranded Brazilian coffee beans;
- ➢ Delivery terms. E.g. Associated Enterprise 1 in Figure 4.D.1 sells similar bicycles to Associated Enterprise 2 and Unrelated Party C. All relevant information on the controlled and uncontrolled transactions is available to Associated Enterprise 1, and hence it is probable that all material differences between the transactions can be recognized.[30] The uncontrolled price can be adjusted for the difference in delivery terms to eliminate the effect of this difference on the price;
- ➢ Volume of sales and related discounts. E.g. Associated Enterprise

[30] It is assumed that the circumstances relating to the controlled and uncontrolled transactions are similar. The only material difference that could be identified between the transactions is that the price relating to the controlled transaction is a delivered price (i.e. including transportation and insurance), while the uncontrolled transaction #3 is made *ex works*, with the buyer taking responsibility from the named place of delivery, which is Associated Enterprise 1's factory (the "works"). It is possible to perform reasonably accurate adjustments for this difference.

1 sells 5,000 bicycles to Associated Enterprise 2 for US$90 per bicycle, while it sells 1,000 similar bicycles to Unrelated Party C. The effect of the differences in volume on price should be analyzed, and if the effect is material, adjustments should be made for example based on volume discounts in similar markets;

- Product characteristics. E.g. the uncontrolled transactions to an unrelated party in Figure 4.D.1 involve bicycles on which modifications have been made. However, the bicycles sold in the controlled transactions do not include these modifications. If the product modifications have a material effect on price, then the uncontrolled price should be adjusted to take into account this difference in price;
- Contractual terms. E.g. Associated Enterprise 1 sells the bicycles to Associated Enterprise 2 offering a 90-day credit term but the contract terms dictate that all sales to Unrelated Party C are cash on delivery;
- Allocation of risks. E.g. Associated Enterprise 1 is exposed to inventory risk related to sales by Associated Enterprise 2 and the risk that customers of Associated Enterprise 2 will default on their bicycle purchase loans; whereas in the transaction between Associated Enterprise 1 and Unrelated Party C, the latter is exposed to the inventory risk and the risk of its customers' default. This difference in risk allocation must be analyzed and its effect on price quantified before Associated Party 2's prices and Unrelated Party C's prices can be considered comparable; and
- Geographical factors. E.g. Associated Enterprise 1 sells bicycles to Associated Enterprise 2 located in South Africa, while Unrelated Party C, to which it also sells the same bicycles, is located in Egypt. The only material difference that could be identified between the controlled and uncontrolled transactions concerns the locale. To perform adjustments to account for this difference one might have to consider, for example, differences in inflation rates between South Africa and Egypt, the competitiveness of the bicycle market in the two countries and differences in government regulations if relevant.

4.2.2.6 Reasonably accurate adjustments may not be possible for:

- Unique and valuable trademarks. E.g. assuming Associated Enterprise 1 in Figure 4.D.1 is engaged in manufacturing high value branded goods, and attaches its valuable trademark to the goods transferred in the controlled transaction, while uncontrolled transaction #1 concerns the transfer of goods that are not branded. The effect of the trademark on the price of a watch may be material. However, it will be difficult, if not impossible, to adjust for the effect of the trademark on price since the trademark is an intangible asset that is unique. If reasonably accurate adjustments cannot be made to account for a material product difference the CUP Method may not be the appropriate method for the transaction; and

- Fundamental differences in the products. E.g. if the products being sold are significantly different from the products sold in the proposed comparable transaction it may not be possible to adjust for the product differences.

4.2.2.7 Notwithstanding the difficulties often associated with adjustments to address the sources of non-comparability described above, the need to make adjustments should not automatically prevent the use of the CUP Method. It is often possible to perform reasonably accurate adjustments. Where there are material differences between the transactions, if reasonable adjustments cannot be performed the reliability of the CUP Method is decreased. In these circumstances another transfer pricing method may be more appropriate.

4.2.3 Strengths and Weaknesses of the Comparable Uncontrolled Price (CUP) Method

4.2.3.1 The strengths of the CUP Method include that it:

- Is a two-sided analysis as the price used reflects the agreed price between two unrelated parties to the transaction;
- Avoids the issue of which of the related parties involved in the controlled transaction should be treated as the tested party for transfer pricing purposes;[31]
- Involves a direct transactional comparison of a similar transaction between unrelated parties. That is, it is a more direct measure of the arm's length price than the other methods, all of which

[31] This issue arises if the other two traditional transaction methods are applied. The other traditional methods determine a transfer price from the perspective of the tested party in the analysis. For example, if the RPM is used, the related party sales company is the tested party in the transfer pricing analysis. If the CPM is used, the related party manufacturer will be the tested party. The resulting transfer prices based on these two methods may very well differ from each other. The choice of the tested party is also significant in the TNMM.

indirectly determine arm's length prices through analysis of the arm's length profits. As it is a more direct measure, the CUP Method is less susceptible to differences in non-transfer pricing factors (such as differences in the accounting treatment of costs between controlled and uncontrolled parties); and

- May be more readily used in instances such as, for example, transactions involving commodity products.

4.2.3.2 The weakness of the CUP Method lies in the difficulty of finding comparable uncontrolled transactions in the light of the comparability standards that must be observed, particularly with respect to the comparability of products, intellectual property or services.

4.2.4 When to Use the Comparable Uncontrolled Price (CUP) Method

4.2.4.1 In cases where comparable uncontrolled transactions can be found, the CUP Method is typically a very reliable method to use in determining whether the terms of commercial and financial transactions between associated enterprises are at arm's length. This implies that an examiner should always consider the feasibility of applying the CUP Method. That is, an examiner should consider whether it is possible to locate acceptable internal comparables or external comparables. With regard to internal comparables therefore, a question that should be asked in any analysis is whether one of the associated enterprises involved is engaged in similar transactions with independent enterprises.

4.2.4.2 In the example represented in Figure 4.D.1 above, this would involve two distinct questions: (i) whether Associated Enterprise 1 sells comparable bicycles to an unrelated party and (ii) whether Associated Enterprise 2 purchases comparable bicycles from one or more unrelated bicycle manufacturers. If the answer to either one of these questions is in the affirmative, then the next step in the analysis is to determine the degree of comparability between the controlled and uncontrolled transactions based on the comparability factors.

4.2.4.3 External comparables may be difficult to find in practice unless the transactions involve a fairly common and homogeneous product or service. However, the advantages of the CUP Method are great enough to warrant a significant effort to apply the method.

4.2.4.4 Experience indicates that the CUP Method will be most useful where:

- One of the associated enterprises involved in the transaction is engaged in comparable uncontrolled transactions with an independent enterprise (i.e. an internal comparable is available). In such a case all relevant information on the uncontrolled transactions is available and it is therefore probable that all material differences between controlled and uncontrolled transactions can be identified; and

- The transactions involve commodity type products, and the differences between the products are minor or can be easily adjusted for.

4.2.5 Case Examples of Use of the Comparable Uncontrolled Price (CUP) Method

4.2.5.1 Example 1: Comparable Sales of Same Product

MCO, a manufacturer, sells the same product to both controlled and uncontrolled distributors. The circumstances surrounding the controlled and uncontrolled transactions are substantially the same, except that the controlled sales price is a delivered price and the uncontrolled sales are made free on board (f.o.b.) MCO's factory (which means the buyer takes responsibility for delivery costs of the goods for the remainder of their transit). Differences in the contractual terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, and adjustments are made to the results of the uncontrolled transaction to account for such differences. No other material difference has been identified between the controlled and uncontrolled transactions. As MCO is engaged in both controlled and uncontrolled transactions, it is likely that all material differences between the two transactions have been identified. In this case, the CUP Method is applied to an uncontrolled comparable with no product differences, and there are only minor contractual differences that have a definite and reasonably ascertainable effect on price. The results of this application of the CUP Method will therefore provide the most direct and reliable measure of an arm's length result.

4.2.5.2 Example 2: Effect of Trademark

The facts are the same as in Example 1 except that MCO affixes its valuable trademark to the property sold in the controlled transactions but does not affix its trademark to the property sold in the uncontrolled transactions. Under the facts of this case the effect on price of the trademark is material and cannot be reliably estimated. As there are material product differences for which reliable adjustments cannot be made the CUP Method is unlikely to provide a reliable measure of the arm's length result.

4.2.5.3 Example 3: Minor Product Differences

> The facts are the same as in Example 1 except that MCO, which manufactures business machines, makes minor modifications to the physical properties of the machines to satisfy specific requirements of a customer in controlled sales. MCO does not, however, make these modifications in uncontrolled sales. Only if the minor physical differences in the product have a material and reasonably ascertainable effect on prices should adjustments be made to the results of the uncontrolled transactions to account for these differences. These adjusted results may then be used as a measure of the arm's length result.

4.2.5.4 Example 4: Effect of Geographic Differences

> FM, a specialty radio manufacturer, sells its radios to a controlled distributor, AM, within the western region of Country A. FM sells its radios to uncontrolled distributors to serve other regions in Country A. The product sold in the controlled and uncontrolled transactions is the same and all other circumstances surrounding the controlled and uncontrolled transactions are substantially the same other than the geographic differences. If the geographic differences are unlikely to have a material effect on price, or they have definite and reasonably ascertainable effects for which adjustments are made, then the (adjusted) results of the uncontrolled sales may be used under the CUP Method to establish an arm's length price. If the effects of the geographic differences would be material but cannot be reliably ascertained, then the reliability of the results will be diminished. However, the CUP Method may still provide the most reliable measure of an arm's length result relative to the application of other transfer pricing methods.

4.3 Traditional Transaction Methods: Resale Price Method (RPM)

4.3.1 Introduction to the Resale Price Method

4.3.1.1 The RPM is one of the traditional transaction methods that can be used to determine whether a transaction reflects the arm's length principle. The RPM focuses on the related sales company which performs marketing and selling functions as the tested party in the transfer pricing analysis. This is depicted in Figure 4.D.2 below.

4.3.1.2 The RPM analyzes the price of a product that a related sales company (i.e. Associated Enterprise 2 in Figure 4.D.2) charges to an unrelated customer (i.e. the resale price) to determine an arm's length gross margin, which the sales company retains to cover its sales, general and administrative (SG&A) expenses, and still make an appropriate profit. The appropriate profit level is based on the functions it performs, the assets it uses and the risks it assumes. The remainder of the product's price is regarded as the arm's length price for the intragroup transactions between the sales company (i.e. Associated Enterprise 2) and a related company (i.e. Associated Enterprise 1). As the method is based on arm's length gross profits rather than directly determining arm's length prices (as with the CUP Method) the RPM requires less direct transactional (product) comparability than the CUP Method.

Figure 4.D.2
Resale Price Method (RPM)

4.3.1.3 Consequently, under the RPM the starting point of the analysis for using the method is the sales company. Under this method the transfer price for the sale of products between the sales company (i.e. Associated Enterprise 2) and a related company (i.e. Associated Enterprise 1) can be described in

Resale price	=	US$100
Resale price margin (25%)	=	US$ 25
Arm's length transfer price	=	US$ 75

the following formula:

TP = RSP x (1-GPM), where:

- TP = the *Transfer Price* of a product sold between a sales company and a related company;
- RSP = the *Resale Price* at which a product is sold by a sales company to unrelated customers; and
- GPM = the *Gross Profit Margin* that a specific sales company should earn, defined as the ratio of gross profit to net sales. Gross profit is defined as Net Sales minus Cost of Goods Sold.

4.3.1.4 **Example of Resale Price Method (RPM) Application**

> It is assumed that the resale price in Figure 4.D.2 is $100. This means that Associated Enterprise 2 resells the bicycle to Independent Enterprise for $100. If we determine, based on evidence from independent comparables, that an arm's length gross profit margin that Associated Enterprise 2 should earn is 25 per cent, Associated Enterprise 2 should cover its SG&A expenses and make an appropriate profit with this 25 per cent gross margin. The resulting transfer price between Associated Enterprise 1 and Associated Enterprise 2 (i.e. the cost of goods sold of Associated Enterprise 2) is $75 (i.e. $100 (1–0.25).

4.3.1.5 Other approaches are possible. For example, if the associated enterprise acts as a sales agent that does not take title to the goods, it is possible to use the commission earned by the sales agent (represented as a percentage of the uncontrolled sales price of the goods concerned) as the comparable gross profit margin. The resale price margin for a reseller should always be determined by taking into account the functions performed, assets used or contributed and risks assumed by the reseller.

4.3.2 Arm's Length Gross Profit Margin

4.3.2.1 The financial ratio analyzed under the Resale Price Method (RPM) is the gross profit margin. Gross profit is defined as net sales minus cost of goods sold. It is easiest to determine where the reseller does not add substantially to the value of the product. The net sales figure of a sales company is the sales revenue obtained from selling products to unrelated customers, while the cost of goods sold equals the cost of purchasing the goods sold plus certain additional non-operating costs. Thus, if we are determining the gross margin for products purchased from a related company, the cost of goods sold will include the transfer price paid to the related party (often a manufacturer).

4.3.2.2 Accounting consistency is extremely important in applying the RPM. Gross profit margins will not be comparable if accounting principles and/or practices differ between the controlled transaction and the uncontrolled transaction. For example, the comparable distributors may differ from the related sales company in reporting certain costs (e.g. discounts, transportation costs, insurance and costs of performing the warranty function) as operating expenses or as cost of goods sold. Differences in inventory valuation methods will also affect the gross margins. It is thus important that the analysis does not compare "apples with oranges" but rather "apples with apples". Appropriate adjustments may need to be applied to the data used in computing the gross margin to make sure that "similar" gross margins are compared.

4.3.3 Transactional Comparison Versus Functional Comparison

4.3.3.1 The arm's length price or margin can result from looking at comparable functionality (distributors of broadly similar types of product) or from making a transactional comparison by looking at each transaction the tested party engages in involving comparable products (i.e. sales of different types of bicycles).

4.3.3.2 The arm's length (range of) gross profit margin(s) to be earned by the sales company in the controlled transaction can therefore be determined in the following two ways:

- By transactional comparison: for example, one could determine the gross profit margin that Associated Enterprise 2 earns when reselling bicycles purchased from an independent manufacturer in a comparable uncontrolled transaction. This uncontrolled transaction may initially have been rejected as an internal comparable for purposes of applying the CUP Method because, for example, the transaction involves a different type of bicycle. If the sale of recreational bicycles is at issue, but the unrelated transactions involve bicycle rickshaws (pedicabs) or the like this may involve broadly similar products with comparable accounting measures of Costs of Goods Sold (COGS) making gross margin comparisons sufficiently reliable; and
- By functional comparison: the gross profit margins earned by independent companies in comparable uncontrolled transactions performing functions, using assets and assuming risks comparable to the functions performed, assets used or contributed and risks assumed by Associated Enterprise 2. Functional comparison thus involves a search for comparable distribution companies rather than comparable transactions. This could, for example, include comparable distributors of wheelbarrows and carts.

4.3.3.3 In practice, transactional comparisons are more likely to achieve broad product and accounting consistency than functional comparisons. However, it is sometimes not necessary to conduct a resale price analysis for each individual product line distributed by a sales company under this method. Instead, the RPM is used in those situations to determine the gross margin a sales company should earn over its full range of (aggregated) products.

4.3.4 Comparability in Applying the Resale Price Method (RPM)

4.3.4.1 An uncontrolled transaction is considered comparable to a controlled transaction if:

- There are no differences between the transactions being compared that materially affect the gross margin (for example, contractual terms, freight terms etc.); or
- Reasonably accurate adjustments can be performed to eliminate the effect of such differences.

4.3.4.2 As noted above, the RPM is more typically applied on a functional than on a transactional basis so that functional comparability is typically more important than product comparability. Product differences will probably be less critical for the RPM applied on a functional basis than for the CUP Method, because it is less probable that product differences will have a material effect on profit margins than on price. One would expect a similar level of compensation for performing similar functions across different activities.

4.3.4.3 While product differences may be more acceptable in applying the RPM as compared to the CUP Method, the property transferred should still be broadly similar in the controlled and uncontrolled transactions. Significant differences between the nature of the products sold in the controlled and uncontrolled transactions may reflect differences in functions performed, assets used or contributed or risks assumed. Such differences might suggest differences in arm's length gross margins.

4.3.4.4 The compensation for a distribution company should generally be the same whether it sells washing machines or dryers, because the functions performed (including risks assumed and assets used or contributed) are similar for the two activities. It should also be noted, however, that distributors engaged in the sale of markedly different products cannot be compared. The price of a washing machine will, of course, differ from the price of a dryer, as the two products are not substitutes for each other. Although product comparability is less important under the RPM, greater product similarity is likely to provide more reliable transfer pricing results. It is not always necessary to conduct a resale price analysis for each individual product line distributed by the sales company. Instead, the RPM can be applied more broadly, for example based on the gross margin a sales company should earn over its full range of broadly similar products.

4.3.4.5 As the gross profit margin remunerates a sales company for performing marketing and selling functions; the RPM especially depends on comparability regarding functions performed, risks assumed and assets used or contributed. The RPM thus focuses on functional comparability. A similar level of compensation is expected for performing similar functions (using similar assets and assuming similar risks) across different activities. If there are material differences that affect the gross margins earned in the controlled and the uncontrolled transactions, adjustments should be made to account for such differences. In general, comparability adjustments should be performed on the gross profit margins of the uncontrolled transactions. The operating expenses in connection with the functions performed, assets used or contributed and risks assumed should be taken into account in this respect, as these differences are frequently reflected in different operating expenses.

4.3.4.6 The following issues should be considered in determining whether the functions performed, assets used or contributed and risks assumed by an uncontrolled entity are comparable to those of a controlled entity for purposes of applying the RPM:

- In contrast to the CUP Method, the reliability of the RPM can be influenced by factors that have less effect on the price of a product than on the costs of performing functions. Such differences could affect gross margins even if they do not affect the arm's length prices of products (e.g. the composition of COGS). These factors could include cost structures (e.g. accounting practices), business experience (e.g. start-up phase or mature business) or management efficiency;
- A resale price margin requires particular attention where the reseller adds substantially to the value of the product, for example by assisting considerably in the creation or maintenance of intangibles related to the product (e.g. trademarks or trade names) or where goods are further processed into a more complicated product by the reseller before resale;
- The amount of the resale price margin will be affected by the level of activities performed by the reseller. For example, the distribution services provided by a reseller acting as a sales agent will be less extensive than those provided by a reseller acting as a buy-sell distributor. The buy-sell distributor will obviously obtain a higher compensation than the sales agent;

- If the reseller performs a significant commercial activity in relation to the resale activity itself, or if it employs valuable and unique assets in its activities (e.g. valuable marketing intangibles of the reseller), it may earn a higher gross profit margin;
- The comparability analysis should try to take into account whether the reseller has the exclusive right to resell the goods, because exclusive rights may affect the resale price margin;
- The analysis should consider differences in accounting practices that apply to the reseller and to comparable companies in order to make appropriate adjustments to enhance comparability; and
- The reliability of the analysis will be affected by differences in the value of the products distributed, for example, as a result of a valuable trademark.

4.3.4.7 It should be recognized that returns to similar functions (bearing in mind assets used or contributed and risks assumed) may not be the same in different markets. Generally, reliability is enhanced when the reseller and the comparable companies are operating in the same market.

4.3.5 Strengths and Weaknesses of the Resale Price Method (RPM)

4.3.5.1 The strengths of the RPM include:

- The method is based on the resale price, a market price, and thus represents a demand-driven method; in situations where there is a weak relationship between the costs incurred and the sales price of a product or services (e.g. when demand is inelastic), the resale price may be more reliable; and
- The method can be used without forcing distributors to inappropriately "make profits". The distributor earns an arm's length gross profit margin. However, in some circumstances the distributor could legitimately have operating losses which are not due to the transfer price but rather are the result of commercial factors, for example, high selling expenses caused by business strategies such as a market penetration strategy. By comparison, the application of the TNMM, which analyzes a financial ratio based on operating profits, will generally result in an arm's length range of positive operating profits. The tested party in the analysis would then generally be expected also to earn a positive operating profit within the range. However, the RPM does not necessarily result in positive operating profits to be earned by

the tested party.

4.3.5.2 The weaknesses of the RPM include:

- It may be difficult to find comparable data on gross margins due to accounting inconsistencies; and
- The method involves a one-sided analysis, as its focus is on the related sales company as the tested party in the transfer pricing analysis. It is possible that the arm's length gross profit margin and hence transfer price, which is based on a benchmarking analysis, can lead to an extreme result for the related supplier of the sales company (e.g. the supplier might experience a loss even though its distributor is profitable).

4.3.6 When to Use the Resale Price Method (RPM)

4.3.6.1 In a typical intragroup transaction involving a "fully-fledged" manufacturer (i.e. as compared, for example, with a limited risk or contract manufacturer) owning valuable patents or other intangibles and affiliated sales companies which purchase and resell the products to unrelated customers, the RPM is an appropriate method to use if:

- The CUP Method is not applicable;
- The sales companies do not own or contribute to valuable intangibles; and
- Reliable comparisons with uncontrolled transactions can be made on COGS.

4.3.6.2 It is useful to again consider the example of Figure 4.D.2. It is assumed here that Associated Enterprise 1 owns valuable patents to manufacture the bicycles and has a valuable trade name. Associated Enterprise 2 purchases the bicycles from Associated Enterprise 1 and resells the bicycles to unrelated dealers in the local country. In such a case, the RPM will be selected to determine an arm's length transfer price between Associated Enterprise 1 and Associated Enterprise 2 if the CUP Method cannot be applied. The CPM (discussed below) will not be selected in this case, because:

- The fully-fledged manufacturer (i.e. Associated Enterprise 1) owns unique and valuable intangibles, performs R&D activities and generally has operations that are more complex than those of the sales company (i.e. Associated Enterprise 2);
- The results obtained from applying the CPM will not be as reliable as the results obtained from applying the RPM using the sales company as the tested party; and

- ➢ It will be very difficult, if not impossible, to identify manufacturers comparable to Associated Enterprise 1 (i.e. that own comparable intangibles) when applying the CPM.

4.3.6.3 The RPM will establish the transfer price by reference to the resale or gross margins (gross profit/net sales) earned by third-party resellers (assuming that no internal comparables are available) and compare them to the gross margin earned by Associated Enterprise 2 on the bicycles purchased from related parties.

4.3.6.4 The RPM may also be applied in a commissionaire/ commission agent structure involving a principal and related commissionaires/commission agents. In this case, the RPM will establish an arm's length commission to be earned by the commissionaires/commission agents.

4.3.7 Case Examples of the Resale Price Method (RPM)

4.3.7.1 **Example 1**

A controlled taxpayer sells property to another member of its group which resells the property to an unrelated customer. It is assumed that there are no material changes in the beginning and ending inventory for the year under review. Information regarding an uncontrolled comparable is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and reliably adjusted for. If the applicable resale price of the property involved in the controlled sale is \$100 and if the reseller in the comparable uncontrolled transaction earns a gross profit margin of 20 per cent, then an arm's length result for the controlled sale is a price of \$80 (\$100−(0.20 × \$100)).

4.3.7.2 **Example 2**

SCO, a Country B corporation, is the distributor for FP, its foreign parent. There are no material changes in the beginning and ending inventory for the year under review. SCO's total reported cost of goods sold is \$800, consisting of \$600 for property purchased from FP and \$200 for other costs of goods sold incurred to unrelated parties. SCO's applicable resale price and reported gross profit are as follows:

Applicable resale price	$1 000
Cost of goods sold:	
Cost of purchases from FP	$600
Costs incurred to unrelated parties	$200
Reported gross profit	$200

The local taxing authority determines that the appropriate gross profit margin is 25 per cent by referring to the gross profit margin earned by an independent reseller in a comparable uncontrolled transaction. Therefore, SCO's appropriate gross profit is $250 (i.e. 25 per cent of the applicable resale price of $1,000). As SCO is incurring costs of sales to unrelated parties, an arm's length price for property purchased from FP must be determined under a two-step process. First, the appropriate gross profit ($250) is subtracted from the applicable resale price ($1,000). The resulting amount ($750) is then reduced by the costs of sales incurred to unrelated parties ($200). Therefore, an arm's length price for SCO's purchases from FP in this case should be $550 (i.e. $750 minus $200) and not $600.

4.3.7.3 **Example 3**

TCO, a Country T corporation, is the exclusive distributor of products for its foreign parent. To determine whether the gross profit margin of 25 per cent earned by TCO is an arm's length result, the local taxing authority considers applying the Resale Price Method. There are several uncontrolled distributors that perform similar functions under similar circumstances in uncontrolled transactions. However, the uncontrolled distributors treat certain costs such as discounts and insurance as cost of goods sold, while TCO treats such costs as operating expenses. In such cases, accounting reclassifications must be made to ensure consistent treatment of such material items. Inability to make such accounting reclassifications will decrease the reliability of the results of applying the Resale Price Method based on the results of the uncontrolled transactions.

4.3.7.4 Example 4

WCO, a Country W corporation, manufactures Product Z, an unbranded product, and sells it to RCO, its wholly owned foreign subsidiary. RCO acts as a distributor of Product Z in Country R, and sells it to uncontrolled parties in that country. Uncontrolled Distributors A, B, C, D and E distribute competing products of approximately similar value in Country R. All such products are unbranded. Relatively complete data are available regarding the functions performed, assets used or contributed and risks assumed by the uncontrolled distributors and the contractual terms under which they operate in the uncontrolled transactions. In addition, data are available to ensure accounting consistency between all of the uncontrolled distributors and RCO. As the available data are sufficiently complete and accurate to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, and reliable adjustments are made to account for such differences, the results of each of the uncontrolled distributors may be used to establish a range of arm's length resale price margins to apply to the transactions involving RCO.

4.3.7.5 Example 5

The facts are the same as in Example 4, except that sufficient data are not available to determine whether any of the uncontrolled distributors provide warranties or to determine the payment terms of the contracts. As differences in these contractual terms could materially affect price or profits, the inability to determine whether these differences exist between the controlled and uncontrolled transactions diminishes the reliability of the results of the uncontrolled comparables. However, the reliability of the results may be enhanced by the application of a statistical method when establishing an arm's length range.

4.3.7.6 Example 6

The facts are the same as in Example 4, except that Product Z is branded with a valuable trademark that is owned and was developed by WCO. Companies A, B and C distribute unbranded competing products, while Companies D and E distribute products branded with other trademarks.

Companies D and E do not own any rights in the trademarks under which their products are sold. The value of the products that Companies A, B and C sell are not similar to the value of the products sold by S. The value of products sold by Companies D and E, however, is similar to that of Product X.

Although close product similarity is not as important for a reliable application of the Resale Price Method as for the Comparable Uncontrolled Price Method, significant differences in the value of the products involved in the controlled and uncontrolled transactions may affect the reliability of the results. In addition, because in this case it is difficult to determine the effect the trademark will have on price or profits, reliable adjustments for the differences cannot be made. Because transactions involving Companies D and E have a higher level of comparability than those involving Companies A, B and C with Company S, only transactions involving Companies D and E should be included in determining the arm's length gross margin.

4.4 Traditional Transaction Methods: Cost Plus Method (CPM)

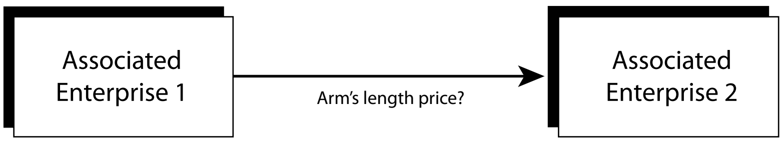
4.4.1 Introduction to the CPM

4.4.1.1 In a controlled transaction involving a sale of tangible property, the CPM generally focuses on the related manufacturing company as the tested party in the transfer pricing analysis. The CPM may also be used in the case of services rendered, in which case the service provider is generally designated as the tested party.

4.4.1.2 The CPM begins with the costs incurred by the supplier of property or services in a controlled sale of property or services to a related purchaser. An appropriate cost plus mark-up is then added to this cost, to calculate an appropriate gross profit in light of the functions performed, risks assumed, assets used or contributed and market conditions.

4.4.1.3 The CPM is most often used to analyze transfer pricing issues involving tangible property or services. It is typically applied to manufacturing or assembling activities and relatively simple service providers. The method evaluates the arm's length nature of an intragroup charge by reference to the gross profit mark-up on costs earned by independent suppliers of tangible property or services in comparable uncontrolled transactions. That is, it compares the gross profit mark-up earned by the tested party for manufacturing the product or for providing the service to the gross profit mark-ups earned by comparable companies engaged in comparable transactions.

Figure 4.D.3
Cost Plus Method (CPM)



Cost of Associated Enterprise 1	=	$500
+ Gross profit mark-up (50%)	=	$250
Arm's length price	=	$750

It is assumed that the COGS in Figure 4.D.3. is $500. If it is assumed also that an arm's length gross profit mark-up that Associated Enterprise 1 should earn, based on the financial results of identified comparables, is 50 per cent, the resulting transfer price between Associated Enterprise 1 and Associated Enterprise 2 is $750 (i.e. $500 x (1 + 0.50).

Like the RPM, the CPM is a gross margin method; that is, it attempts to derive an arm's length amount of gross profit, in this case through an arm's length mark-up on COGS.

4.4.1.4 Figure 4.D.3. explains this further. Associated Enterprise 1, an electrical goods manufacturer in Country 1, manufactures under contract for Associated Enterprise 2. Associated Enterprise 2 instructs Associated Enterprise 1 on the quantity and quality of the goods to be produced. Associated Enterprise 1 will be guaranteed sales to Associated Enterprise 2 and will face little risk. As Associated Enterprise 1 is less complex in terms of functions, assets and risks than Associated Enterprise 2, the analysis under the CPM would focus on Associated Enterprise 1 as the tested party. Since Associated Enterprise 1 is a simple manufacturer, the CPM may be the best method of analysis in this case. The CPM analyzes whether the gross profit mark-up earned by Associated Enterprise 1 is at arm's length by reference to the gross profit margins earned by companies manufacturing comparable goods for (or providing comparable services to) unrelated parties. The CPM thus does not directly test whether the transfer price is at arm's length by comparing prices. As such, it is a less direct (transactional) method as compared to the CUP Method.

4.4.2 Mechanism of the Cost Plus Method (CPM)

4.4.2.1 Under the CPM (when applied to sales of tangible property) an arm's length price equals the controlled party's cost of producing the tangible property plus an appropriate gross profit mark-up, defined as the ratio of gross profit to cost of goods sold (excluding operating expenses) for a comparable uncontrolled transaction.

4.4.2.2 The formula for the transfer price in inter-company transactions of products is as follows: TP = COGS x (1 + cost plus mark-up), where:

- TP = the *Transfer Price* of a product sold between a manufacturing company and a related company;
- COGS = the *Cost of Goods Sold* to the manufacturing company; and
- Cost plus mark-up = gross profit mark-up defined as the ratio of gross profit to cost of goods sold. Gross profit is defined as net sales minus cost of goods sold.

4.4.3 Arm's Length Gross Profit Mark-up for Cost Plus Method (CPM)

4.4.3.1 The financial ratio considered under the CPM is the gross profit mark-up, which is defined as the ratio of gross profit to cost of goods sold of the supplier of products or services. As discussed above, gross profit equals net sales minus cost of goods sold. For a manufacturing company, cost of goods sold equals the cost of producing the goods sold. It includes direct labour costs, direct material costs and factory overheads associated with production.

4.4.3.2 As with the RPM, accounting consistency is extremely important in applying the CPM. Application of different accounting principles to the controlled and the uncontrolled transaction may result in inconsistent calculation of the gross profit. Appropriate adjustments of accounting principles may be necessary to ensure that gross profit mark-ups are calculated uniformly for the tested party and the comparable companies. For example, the comparable manufacturers may differ from the related party manufacturer in reporting certain costs (e.g. costs of R&D) as operating expenses or as cost of goods sold. Differences in inventory valuation methods will also affect the computation of the gross profit mark-up.

4.4.3.3 The costs and expenses of a company normally fall into the following three groups: (1) direct cost of producing a product or service (e.g. cost of raw materials); (2) indirect costs of production (e.g. costs of a repair department that services equipment used to manufacture different products); and (3) operating expenses (e.g. selling, general & administrative expenses or SG&A expenses). The gross profit margin used in the CPM is a profit margin that is calculated by subtracting only the direct and indirect costs of production from the sales price. In contrast, a net margin analysis would also consider operating expenses. Due to differences in accounting standards between countries, the boundaries between the three groups of costs and expenses are not the same in each and every case. Suitable adjustments may need to be made. In a situation in which it is necessary to consider certain operating expenses to obtain consistency and comparability, a net margin method may be more reliable than the CPM, as discussed below.

4.4.3.4 **Example: Accounting Consistency Issue**

It is assumed that Associated Enterprise 1, a bicycle manufacturer that manufactures bicycles under contract for Associated Enterprise 2, earns a gross profit mark-up of 15 per cent on its cost of goods sold and classifies certain expenses (such as warranty expenses) as operating expenses that are not part of cost of goods sold. Four comparable independent manufacturers are identified which earn gross profit mark-ups between 10 per cent and 15 per cent. However, these comparable companies account for those particular (warranty) expenses as part of cost of goods sold. The unadjusted gross profit mark-ups of these comparables are thus not calculated on the basis of the same costs as the gross profit mark-up of Associated Enterprise 1. Unless reliable adjustments can be made to the calculation of the gross profit mark-ups of the uncontrolled transactions or, in the alternative, of Associated Enterprise 1, for purposes of consistency, a net margin method may be more reliable.

4.4.4 Transactional Comparison Versus Functional Comparison

4.4.4.1 The arm's length price or margin can result from looking at comparable functionality (manufacturers of broadly similar types of product) or from making a transactional comparison by looking at each transaction the tested party engages in involving comparable products (e.g. manufacturing of different types of bicycle).

4.4.4.2 The arm's length (range of) gross profit mark-up(s) can be established in the following two ways:

- Transactional comparison: the gross profit mark-up earned by the related party manufacturer when selling goods to an independent enterprise in a comparable uncontrolled transaction, which previously has been rejected as an internal comparable for purposes of applying the CUP Method because for example it involves different models of bicycle. If for example the controlled transaction involves the manufacturing of recreational bicycles, but the unrelated transactions involve bicycle rickshaws etc., these may involve broadly similar products, with comparable accounting measures of COGS making gross margin comparisons sufficiently reliable; and
- Functional comparison: the gross profit mark-ups earned by independent companies performing functions and incurring risks comparable to the functions performed and risks incurred by the related party manufacturer. Functional comparison involves a search for comparable manufacturing companies.

4.4.4.3 In practice, transactional comparisons are more likely to achieve the broad product and accounting consistency required for the CPM than functional comparisons. In a transactional comparison, much more information about the controlled and uncontrolled transactions is available (e.g. contractual terms). In a functional comparison that is based on information provided in publicly available databases and in the annual reports of comparable companies and the tested party, much less specific information is available with respect to the functions performed and risks incurred by the companies. Consequently, it would be more likely in these circumstances that a net margin method would be used, see paragraph 4.5.2.

4.4.4.4 Based on benchmarking and financial analyses an arm's length range of gross profit mark-ups earned by comparable independent manufacturers will be determined. If the gross profit mark-up earned by the related party manufacturer falls within this range, then its transfer price will be considered arm's length.

4.4.5 Comparability

4.4.5.1 An uncontrolled transaction is considered comparable to a controlled transaction in applying the CPM if:

- There are no differences between the transactions being compared that materially affect the gross profit mark-up; or

- Reasonably accurate adjustments can be performed to adjust for the effect of such differences.

4.4.5.2 As with the RPM, and for the same reasons, close similarity of products in the controlled and uncontrolled transactions is less important under the CPM than under the CUP Method, while functional comparability (including comparability of risks assumed and assets used or contributed) is more important. However, because significant differences in products may necessarily result in significant differences in functions, assets and risks, the controlled and uncontrolled transactions should ideally involve the provision of similar services or the manufacturing of products within the same product family.

4.4.5.3 As the gross profit mark-up remunerates a manufacturing or service company for performing a manufacturing or service function, the CPM necessarily requires functional comparability. If there are material differences in functions performed, assets used or contributed and risks assumed that affect the gross profit mark-ups achieved on the controlled and the uncontrolled transactions, adjustments should be made to account for such differences. In general, comparability adjustments should be made on the gross profit mark-ups of the uncontrolled transactions. Sometimes the operating expenses in connection with the functions performed will need to be taken into account because differences in functions performed may be reflected in the operating expenses, as service providers may very well have no COGS.

4.4.6 Determination of Costs

4.4.6.1 Application of the CPM entails a number of potential difficulties associated with the determination of the costs (in addition to those associated with inconsistent accounting treatments):

- The link between costs incurred and the market price can be very weak so that gross profit margins can vary greatly each year;
- It is important to apply a comparable mark-up to a comparable cost base;
- Differences between the tested party and potential comparables should be identified. In this respect, it is crucial to consider differences in the level and types of expenses in connection with the functions performed, assets used or contributed and risks assumed between the controlled and uncontrolled transactions. If differences merely represent the differing efficiencies of the parties being compared, no adjustment to the gross profit mark-up should be made. If, however, additional functions are

being performed by the tested party, then it may be necessary to determine an appropriate additional return to such function and permit a separate return for these additional functions. Similarly, if the comparables perform functions not performed by the tested party, then the return for such functions should be subtracted from the gross profit margin applied to the controlled transactions of the tested party;

- Careful consideration should be given to what costs should be excluded from the cost base. An example of costs that should be excluded are particular costs that are passed-through (that is, costs explicitly not subject to a mark-up) in both the tested party and comparable transactions;
- As with the Resale Price Method, accounting consistency is extremely important. Gross profit mark-ups should be calculated uniformly for the associated enterprise and the independent enterprises;
- Historical costs should in principle be ascribed to individual units of production. If costs differ over a period, average costs over the period may be used;
- One can use either budgeted cost or actual cost in applying the CPM. On the one hand using actual costs will better reflect the risks faced by a contract manufacturer.[32] On the other hand, third parties will usually use budgeted costs in determining prices of products being sold into the market. That is, they will not charge the customer an additional amount at the end of the year if actual costs are higher than budgeted costs; and
- As the costs considered in using the CPM are only those of the manufacturer of the goods or the service provider, a problem may arise with respect to the allocation of some costs between the manufacturer or service provider and the purchaser of goods or services.

4.4.7 Strengths and Weaknesses of the Cost Plus Method (CPM)

4.4.7.1 The strength of the CPM is that the method is based on internal costs, the information on which is usually readily available to the multinational enterprise.

[32] Note that if the contract is based on actual costs, the contractual terms may include incentives or penalties depending on the performance of the contract manufacturer.

4.4.7.2 The weaknesses of the CPM include the following:

- There may be a weak link between the level of costs and the market price;
- The data on gross profit mark-ups may not be comparable due to accounting inconsistencies and other factors;
- Accounting consistency is required between the controlled and uncontrolled transactions;
- The analysis is one-sided, i.e. it focuses only on the related party manufacturer or service provider; and
- Since the method is based on actual costs, there may be no incentive for the controlled manufacturer to control costs.

4.4.8 When to Use the Cost Plus Method (CPM)

4.4.8.1 The CPM is typically applied in cases involving the intragroup sale of tangible property where the related party manufacturer performs limited manufacturing functions or in the case of intragroup provision of services. The method usually assumes the manufacturer or service provider has low risks, because the level of the costs will then better reflect the value being added and hence the market price.

4.4.8.2 The CPM is also generally used in transactions involving a contract manufacturer, a toll manufacturer or a low risk assembler which does not own product intangibles and assumes little risk. The related customer involved in the controlled transaction will generally be much more complex than the manufacturer (or service provider) in terms of functions performed (e.g. conducting marketing and selling functions, coordination of production and sales, giving instructions to the contract manufacturer about the quantity and quality of production, and purchasing raw materials in some cases), risks assumed (e.g. market risk, credit risk and inventory risk) and assets used or contributed (e.g. product or other intangibles). The contract manufacturer is thus the less complex and as such should be the tested party in the transfer pricing analysis.

4.4.8.3 The CPM is usually not a suitable method to use in transactions involving a fully-fledged manufacturer which owns or develops unique and valuable product intangibles as it will be very difficult to locate independent manufacturers with comparable product intangibles. That is, it will be hard to establish a profit mark-up that is required to remunerate the fully-fledged manufacturer for its unique and valuable intangibles. In a typical transaction structure involving a fully-fledged manufacturer and related sales companies (e.g. commissionaires), the sales companies will normally be the less complex entities involved in the controlled transactions and will therefore be the tested party in the analysis. The RPM is typically more easily applied in such cases.

4.4.9 Case Examples of the Cost Plus Method (CPM)

4.4.9.1 **Example 1**

LCO, a domestic manufacturer of computer components, sells its products to FS, its foreign distributor. UT1, UT2 and UT3 are domestic computer component manufacturers that sell to uncontrolled foreign purchasers.

Relatively complete data are available regarding the functions performed, assets used or contributed and risks borne by UT1, UT2 and UT3, and the contractual terms in the uncontrolled transactions. In addition, data are available to ensure accounting consistency between all the uncontrolled manufacturers and LCO. The available data are sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, and reliable adjustments are made to account for the differences. An acceptable range of arm's length cost plus mark-ups can thus be established.

4.4.9.2 **Example 2**

The facts are the same as in Example 1 except that LCO accounts for supervisory, general and administrative costs as operating expenses, which are not allocated to its sales to FS. The gross profit mark-ups of UT1, UT2 and UT3, however, reflect supervisory, general and administrative expenses because they are accounted for as costs of goods sold. Accordingly, the gross profit mark-ups of UT1, UT2 and UT3 must be adjusted to provide accounting consistency. If data are not sufficient to determine whether such accounting differences exist between the controlled and uncontrolled transactions the reliability of the results will be diminished.

4.4.9.3 **Example 3**

The facts are the same as in Example 1 above, except that under its contract with FS, LCO uses materials consigned by FS. UT1, UT2 and UT3, on the other hand, purchase their own materials, and their gross profit mark-ups are determined by including the costs of the materials. The fact that LCO does not carry an inventory risk by purchasing its own materials, while the uncontrolled producers carry inventory, is a significant difference that may require an adjustment if the difference has a material effect on the gross profit mark-ups of the uncontrolled producers. Inability to reasonably ascertain the effect of the difference on the gross profit mark-ups will affect the reliability of the comparison between the tested party and UT1, UT2 and UT3.

4.4.9.4 **Example 4**

FS, a foreign corporation, produces apparel for PCO, its parent corporation. FS purchases its materials from unrelated suppliers and produces the apparel according to designs provided by PCO. The local taxing authority identifies ten uncontrolled foreign apparel producers that operate in the same geographic market and are similar in many respects to FS.

Relatively complete data are available regarding the functions performed, assets used or contributed and risks borne by the uncontrolled producers. In addition, data are sufficiently detailed to permit adjustments for differences in accounting practices. However, sufficient data are not available to determine whether it is likely that all material differences in contractual terms have been identified. For example, it is not possible to determine which parties in the uncontrolled transactions bear currency risks. As the differences in these contractual terms could materially affect price or profits, the inability to determine whether differences exist between the controlled and uncontrolled transactions will diminish the reliability of these results. Therefore, the reliability of the results of the uncontrolled transactions must be enhanced for those comparables to be useful, for example by investigating whether they incur currency risk (through reviewing annual reports and the like).

4.5 Transactional Profit Methods: Transactional Net Margin Method (TNMM)

4.5.1 Introduction

4.5.1.1 Transactional profit methods analyze the profits arising from particular controlled transactions in order to determine whether the transfer price is at arm's length. Transactional profit methods can be divided into two categories; the TNMM and the PSM. This section covers the TNMM and the next section covers the PSM.

4.5.1.2 These methods differ from traditional methods in that the analysis is not necessarily based on particular comparable uncontrolled transactions involving identical or perhaps even broadly comparable products. Often, and depending on the facts and circumstances, the analysis is based on the net return (generally, the earnings before interest, tax and extraordinary items, i.e. EBIT) realized by various companies engaged in a particular line of business (that is, a series of transactions that are appropriate to be aggregated). Among other situations, one of the transactional profit methods, the PSM, being a two-sided method, may be applied when both of the associated enterprises make unique and valuable contributions (e.g. in the form of intangibles). Detailed guidance on when the PSM may be appropriate can be found at section 4.6.3 below.

4.5.1.3 It is rare that enterprises use transactional profit methods to actually determine their prices. However, the profit resulting from a controlled transaction might be quite a good signal to establish whether the transaction was affected by conditions that differ from those that would have been made between independent enterprises in otherwise comparable circumstances. Where complexities make the application of the traditional transaction methods addressed in the previous chapter unreliable, transactional profit methods may prove to be a good solution.

4.5.1.4 Transactional profit methods and particularly the TNMM are also commonly used by taxpayers for practical reasons. The TNMM often provides a useful check on the accuracy and reasonableness of the traditional transaction methods or is used to supplement these methods. In some situations, it may also be easier to find comparables that can be used to apply the TNMM than it is to find transactional comparables that can be used to apply the CUP, Resale Price or CPM.

4.5.2 Transactional Net Margin Method (TNMM)

4.5.2.1 The TNMM examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that are appropriate to be aggregated). The profit margin indicators are discussed below. The TNMM looks at the profits of one of the related parties involved in a transaction, as do the CPM and RPM. The party examined is referred to as the tested party.

4.5.2.2 The TNMM compares the net profit margin[33] (relative to an appropriate base) that the tested party earns in the controlled transactions to the same net profit margins earned by the tested party in comparable uncontrolled transactions or alternatively by independent comparable companies. As it uses net margins to determine arm's length prices the TNMM is a less direct method than the CPM and RPM that compares gross margins. It is also an even more indirect method than the CUP Method that directly compares prices. Many factors may affect net profit margins but may have nothing to do with transfer pricing.

4.5.2.3 The TNMM is used to analyze transfer pricing issues involving tangible property, intangible property or services. It may be applied when one of the associated enterprises employs intangible assets, the appropriate return to which cannot be determined directly. In such a case the arm's length compensation of the associated enterprise(s) not employing the intangible asset is determined by determining the margin realized by enterprises engaged in a similar function with unrelated parties. The remaining return is consequently left to the associated enterprise controlling the intangible asset. The return to the intangible asset is, in practice, a "residual category" being the return left over after other functions have been appropriately compensated at arm's length. This implies that the TNMM is applied to the least complex of the related parties involved in the controlled transaction. This approach has the added benefit that generally more comparable data are available and fewer adjustments are required to account for differences in functions and risks between the controlled and uncontrolled transactions. In addition, the tested party typically does not own valuable intangible property. Where the TNMM is applied in cases that involve intangibles the guidance of chapter 6. of this Manual should be noted. See 6.1.4.

4.5.3 Definition and Choice of Tested Party

4.5.3.1 The TNMM is more tolerant of, and flexible in, accommodating certain minor differences in functionality (where such functions are reflected in operating expenses), and in accounting practices than the RPM or the CPM. Table 4.T.1. below and the paragraphs following it illustrate this distinction.[34]

[33] For example, return on total costs, return on assets, and operating profit to net sales ratio.

[34] All figures and numeric examples are for practical purposes only. They do not reflect actual cases or actual arm's length figures or margins.

Table 4.T.1
Transactional Net Margin Method (TNMM)

Sales price	=	$**10 000**	
Cost of goods sold	=	$?	
Gross profit	=	$?	
Operating expenses	=	$ **2 000**	
Net profit (5% of price)	=	$ 500	*Determined by reference to Comparables*

Associated Enterprise 1, a bicycle manufacturer in Country 1, sells bicycles to Associated Enterprise 2 which resells the bicycles to an independent enterprise, an unrelated bicycle dealer in Country 2. Assume that Associated Enterprise 1 is the more complex party, controlling a variety of technology and operating intangibles. Associated Enterprise 2, on the other hand, is a routine distributor/ reseller which does not make unique and valuable contributions. The CUP Method would compare the price charged in the controlled transaction between Associated Enterprise 1 and Associated Enterprise 2 with the price charged in comparable uncontrolled transactions. If the CUP Method cannot be applied, the CPM and RPM may be considered.

4.5.3.2 The CPM is likely to be relatively unreliable in this case because it would treat the more complex entity, Associated Enterprise 1, as the tested party. Given that Associated Enterprise 2 performs relatively simple activities, the RPM could be considered. Under the RPM, the sales company, the less complex of the two entities involved in the controlled transaction, will be the tested party. The analysis would entail a search for distributors which sell broadly similar products, which perform functions, use or contribute assets and assume risks comparable to those of Associated Enterprise 2, and for which appropriate data relating to gross profits can be obtained.

4.5.3.3 Sometimes it may be more reliable to choose the TNMM and compare net profits. If, for example, there is different reporting of the cost of goods sold and operating expenses for the tested party and the comparable distributors, so that the gross profit margins reported are not comparable and reliable adjustments cannot be made, the RPM may be relatively unreliable. However, this type of accounting inconsistency will not affect the reliability of the TNMM, as this method examines net profit margins instead of gross profit margins. Also, as further discussed below, the fact that the TNMM requires less product comparability than the traditional transaction methods (and as such has a greater tolerance to product differences and cost accounting differences compared to traditional transaction methods) can be a significant practical benefit of using TNMM.

4.5.3.4 The application of the TNMM would entail an analysis of the least complex party—in this case the distributor. Such an analysis would entail a search for comparable distributors taking into account the comparability standard of this method. An application of the TNMM focusing on a related party manufacturer as the tested party could be appropriate in a situation in which Associated Enterprise 1 is instead, a contract manufacturer and has no unique and valuable intangibles. In such a case, the contract manufacturer may be the least complex entity, as MNEs often separate the ownership of valuable technology intangibles from the manufacturing function. The CPM would normally be considered if the CUP Method cannot be applied. However, due to the accounting inconsistency mentioned above, it may be appropriate to apply the TNMM using a financial ratio based on net profit margin that is appropriate for a manufacturer (e.g. return on total costs).

4.5.4 Mechanism of the Transactional Net Margin Method (TNMM)

4.5.4.1 The next question is how to determine the transfer price based on the application of the TNMM. The mechanism of the TNMM is similar to the mechanisms of the RPM and CPM, as can be seen in the following examples.

4.5.4.2 Related party distributor: In applying the RPM to establish an arm's length transfer price, the market price of products resold by the related party distributor to unrelated customers (i.e. sales price) is known, while the arm's length gross profit margin is determined based on the results of comparable uncontrolled transactions, i.e. a benchmarking analysis. The transfer price or cost of goods sold of the related party distributor is the unknown variable. Assuming a resale price of $10,000 and a gross profit margin of 25 per cent, the transfer price amounts to $7,500:

Table 4.T.2
Mechanism of the Resale Price Method (RPM)

	Initially	**Benchmarking analysis**	
Resale price	$10 000	$10 000	
Cost of goods sold	?	7 500	
Gross profit	?	2 500	(25% of resale price)

4.5.4.3 The determination of an arm's length transfer price based on the TNMM is similar. The main difference from a gross margin analysis is that operating expenses are considered in calculating the transfer price. In applying the TNMM to the tested party distributor, the resale price and the operating expenses of the related party distributor are known, while the arm's length net profit margin (i.e. net profit to sales ratio)[35] is found on the basis of a benchmarking analysis. The cost of goods sold and the gross profit are the unknown variables. Assuming a resale price of $10,000, operating expenses of $2,000 and an arm's length net profit margin of 5 per cent, using the TNMM, the transfer price of $7,500 is determined by working backwards using the available information. That is, a transfer price of $7,500 is required to ensure that the distributor earns a net profit margin of 5 per cent.

Table 4.T.3
Mechanism of the Transactional Net Margin Method (TNMM)

	Initially	**Benchmarking analysis**	
Resale price	$10 000	$10 000	
Cost of goods sold	?	7 500	
Gross profit	?	2 500	
Operating expenses	2 000	2 000	
Operating profit	?	500	(5% of resale price)

4.5.4.4 Related party manufacturer: In applying the CPM to establish an arm's length transfer price, the cost of goods sold by the related party manufacturer is known. The arm's length gross profit mark-up is based on a benchmarking analysis. The transfer price or sales revenue of the related party manufacturer is the unknown variable. Assuming cost of goods sold of $5,000 and a gross profit mark-up of 50 per cent, the transfer price amounts to $7,500.

Table 4.T.4
Mechanism of the Cost Plus Method (CPM)

	Initially	**Benchmarking analysis**	
Resale price	?	$7 500	
Cost of goods sold	$5 000	5 000	
Gross profit	?	2 500	(50% of cost of goods sold)

4.5.4.5 In applying the TNMM to the tested party manufacturer instead of the CPM, the cost of goods sold and the operating expenses of the related

35 Net profit equals operating profit before interest and taxes.

party manufacturer are known. A benchmarking analysis will determine the arm's length net profit of the related party manufacturer using a profit level indicator such as the ratio of net profit to total cost. The sales price and the gross profit are the unknown variables. Assuming cost of goods sold of $5,000, operating expenses of $1,000 and an arm's length net profit to total cost ratio of 25 per cent, the transfer price amounts to $7,500. Table 4.T.4. illustrates that working backwards using the available information leads to the determination that the sales price (i.e. transfer price in this case) is $7,500.

Table 4.T.5
Mechanism of the Transactional Net Margin Method (TNMM)

	Initially	**Benchmarking analysis**	
Resale price	?	$7 500	
Cost of goods sold	$5 000	5 000	
Gross profit	?	2 500	
Operating expenses	1 000	1 000	
Operating profit	?	1 500	(25% of total cost)

4.5.5 Examples[36]

4.5.5.1 **Example 1: Transfer of Tangible Property Resulting in No Adjustment**

FP is a publicly traded Country A corporation with a Country B subsidiary named BCO that is under audit for its 2009 taxable year. FP manufactures a consumer product for worldwide distribution. BCO imports the assembled product and distributes it within Country B at the wholesale level under the FP name.

FP does not allow uncontrolled taxpayers to distribute the product. Similar products are produced by other companies but none of them is sold to uncontrolled taxpayers or to uncontrolled distributors.

[36] Adapted from the US Internal Revenue Service Intercompany Transfer Pricing Regulations. Available from https://www.irs.gov/pub/irs-apa/482_regs.pdf.

Based on all the facts and circumstances, Country B's taxing authority determines that the TNMM will provide the most reliable measure of an arm's length result. BCO is selected as the tested party because it engages in activities that are less complex than those undertaken by FP.

	2007	2008	2009	Average
Sales	$500 000	$560 000	$500 000	$520 000
COGS	393 000	412 400	400 000	401 800
Operating expenses	80 000	110 000	104 600	98 200
Operating profit	27 000	37 600	(4 600)	20 000

There is data from a number of independent operators of wholesale distribution businesses. These potential comparables are further narrowed to select companies in the same industry segment that perform similar functions and bear similar risks to BCO. An analysis of the information available on these taxpayers shows that the ratio of operating profit to sales is the most appropriate profit level indicator, and this ratio is relatively stable where at least three years are included in the average. For the taxable years 2007 to 2009, BCO shows the above results.

After adjustments have been made to account for identified material differences between BCO and the uncontrolled distributors, the average ratio of operating profit to sales is calculated for each of the uncontrolled distributors. Applying each ratio to BCO would lead to the comparable operating profit (COP) for BCO shown in the table below.

Uncontrolled Distributor	OP/S (%)	COP ($)
A	1.7	8 840
B	3.1	16 120
C	3.8	19 760
D	4.5	23 400
E	4.7	24 440
F	4.8	24 960
G	4.9	25 480
H	6.7	34 840
I	9.9	51 480
J	10.5	54 600

The data are not sufficiently complete to conclude that it is likely that all material differences between BCO and the uncontrolled distributors have been identified. The Country B taxing authority measures the arm's length range by the interquartile range of results, which consists of the results ranging from $19,760 to $34,840. Although BCO's operating income for 2009 shows a loss of $4,600, the tax authority determines that no allocation should be made, because BCO's average reported operating profit of $20,000 ([$27,000 + $37,600 + $(4,600)]/3) is within the interquartile range, which extends from COP observation 19,760 to 34,840.

4.5.5.2 Example 2: Transfer of Tangible Property Resulting in an Adjustment

The facts are the same as in Example 1 except that BCO reported the following income and expenses:

	2007	2008	2009	Average
Sales	$500 000	$560 000	$500 000	$520 000
COGS	370 000	460 000	400 000	410 000
Operating expenses	110 000	110 000	110 000	110 000
Operating profit	20 000	(10 000)	(10 000)	0

Uncontrolled Distributor	OP/S (%)	COP ($)
C	0.5	2 500
D	1.5	7 500
E	2.0	10 000
A	2.6	13 000
F	2.8	14 000
B	2.9	14 500
J	3.0	15 000
I	4.4	22 000
H	6.9	34 500
G	7.4	37 000

The interquartile range of comparable operating profits remains the same as derived in Example 1: $19,760 to $34,840. BCO's average operating profit for the years 2007 to 2009 ($0) falls outside this range. Therefore, the taxing authority determines that an adjustment may be appropriate. To determine the amount, if any, of the adjustment, the district director compares BCO's reported operating profit for 2009 to comparable operating profits derived from the uncontrolled distributors' results for 2009. The ratio of operating profit to sales in 2009 is calculated for each of the uncontrolled comparables and applied to US Sub's 2009 sales to derive the results shown below. Based on these results, the median of the comparable operating profits for 2009 is $14,250 (the median observation here is the average of observations F $14,000 and B $14,500). Therefore, BCO's income for 2009 is increased by $24,250, the difference between BCO's reported operating profit for 2009 and the median of the comparable operating profits for 2009.

4.5.5.3 **Example 3: Multiple Year Analysis**

The facts are the same as in Example 2. In addition, the taxing authority examines the taxpayer's results for the 2010 taxable year. As in Example 2, the taxing authority increases BCO's income for the 2009 taxable year by $24,250. The results for the 2010 taxable year, together with the 2008 and 2009 taxable years, are as follows:

	2008	**2009**	**2010**	**Average**
Sales	$560 000	$500 000	$530 000	$530 000
COGS	460 000	400 000	430 000	430 000
Operating expenses	110 000	110 000	110 000	110 000
Operating profit	(10 000)	(10 000)	(10 000)	(10 000)

The interquartile range of comparable operating profits, based on average results from the uncontrolled comparables and average sales for BCO for the years 2008 to 2010, ranges from $15,500 to $30,000. In determining whether an adjustment for the 2010 taxable year may be made, the taxing authority compares BCO's average reported operating profit for the years 2008 through 2010 to the interquartile range of average comparable operating profits over this period. BCO's average reported operating profit is determined without regard to the adjustment made with respect to the 2009 taxable year. Therefore, BCO's average reported operating profit for the years 2008 to 2010 is ($10,000). Because this amount of income falls outside the interquartile range, the tax authority determines that an adjustment may be appropriate. To determine the amount, if any, of the adjustment for the 2010 taxable year, the taxing authority compares BCO's reported operating profit for 2010 to the median of the comparable operating profits derived from the uncontrolled distributors' results for 2010. The median of the comparable operating profits derived from the uncontrolled comparables results for the 2010 taxable year is $12,000. Based on this comparison, the taxing authority increases BCO's 2010 taxable income by $22,000, the difference between the median of the comparable operating profits for the 2010 taxable year and BCO's reported operating profit of ($10,000) for the 2010 taxable year.

4.5.5.4 **Example 4: Transfer of Intangible to Offshore Manufacturer**

DCO is a developer, producer and marketer of products. DCO develops a new "high tech product" (HTP) that is manufactured by its foreign subsidiary HCO located in Country H. HCO sells the HTP to JCO (an H Country subsidiary of DCO) for distribution and marketing in Country H. The taxable year 2009 is under audit, and the taxing authority examines whether the royalty rate of 5 per cent paid by HCO to DCO is an arm's length consideration for the HTP technology.

Based on all the facts and circumstances the taxing authority determines that the TNMM will provide the most reliable measure of an arm's length result. HCO is selected as the tested party because it engages in relatively routine manufacturing activities, while DCO engages in a variety of complex activities using unique and valuable intangibles. Finally, because HCO engages in manufacturing activities, it is determined that the ratio of operating profit to operating assets is an appropriate profit level indicator.

Uncontrolled taxpayers performing similar functions cannot be found in Country H. It is determined that data available in Countries M and N provide the best match of companies in a similar market performing similar functions and bearing similar risks. Such data are sufficiently complete to identify many of the material differences between HCO and the uncontrolled comparables and to make adjustments to account for such differences. However, data are not sufficiently complete to ensure that no material differences remain. In particular, the differences in geographic markets might have materially affected the results of the various companies.

In a separate analysis it is determined that the price that HCO charged to JCO for the HTP is an arm's length price. Therefore, HCO's financial data derived from its sales to JCO are reliable. HCO's financial data from 2007 to 2009 are as follows:

	2007	2008	2009	Average
Assets	$24 000	$25 000	$26 000	$25 000
Sales to JCO	25 000	30 000	35 000	30 000
COGS	6 250	7 500	8 750	7 500
Royalty to DCO (5%)	1 250	1 500	1 750	1 500
Other	5 000	6 000	7 000	6 000
Operating expenses	1 000	1 000	1 000	1 000
Operating profit	17 750	21 500	25 250	21 500

Applying the ratios of average operating profit to operating assets for the 2007 to 2009 taxable years (derived from a group of similar uncontrolled comparables located in Countries M and N) to HCO's average operating assets for the same period provides a set of comparable operating profits. The interquartile range for these average comparable operating profits is $3,000 to $4,500. HCO's average reported operating profit for the years 2007 to 2009 ($21,500) falls outside this range. Therefore, the taxing authority auditing 2009 determines that an adjustment may be appropriate for the 2009 taxable year.

To determine the amount, if any, of the adjustment for the 2009 taxable year the tax authority compares HCO's reported operating profit for 2009 to the median of the comparable operating profits derived from the uncontrolled distributors' results for 2009. The median result for the uncontrolled comparables for 2009 is $3,750. Based on this comparison the district director increases royalties that HCO paid by $21,500 (the difference between $25,250 and the median of the comparable operating profits, $3,750).[37]

[37] It is assumed here that the time limit to make adjustments to the years 2007 and 2008 has expired.

4.5.5.5 **Example 5: Adjusting Operating Assets and Operating Profit for Differences in Accounts Receivable**

MCO manufactures parts for industrial equipment and sells them to its foreign parent corporation. For purposes of applying the TNMM, 15 uncontrolled manufacturers that are similar to MCO have been identified. MCO has a significantly lower level of accounts receivable than the uncontrolled manufacturers. Since the rate of return on capital employed is used as the profit level indicator, both operating assets and operating profits must be adjusted to account for this difference. Each uncontrolled comparable's operating assets is reduced by the amount (relative to sales) by which they exceed MCO's accounts receivable. Each uncontrolled comparable's operating profit is adjusted by deducting imputed interest income on the excess accounts receivable. This imputed interest income is calculated by multiplying each uncontrolled comparable's excess accounts receivable by an interest rate appropriate for short-term debt.

4.5.5.6 **Example 6: Adjusting Operating Profit for Differences in Accounts Payable**

KCO is the Country K subsidiary of a foreign corporation. KCO purchases goods from its foreign parent and sells them in the Country K market. For purposes of applying the TNMM, 10 uncontrolled distributors that are similar to KCO have been identified. There are significant differences in the level of accounts payable among the uncontrolled distributors and KCO. To adjust for these differences the taxing authority increases the operating profit of the uncontrolled distributors and KCO to reflect interest expense imputed to the accounts payable. The imputed interest expense for each company is calculated by multiplying each company's accounts payable by an interest rate appropriate for its short-term debt.

4.5.6 Arm's Length Net Profit Margin

4.5.6.1 Several profit level indicators (PLIs) are allowed under the TNMM, typically based on operating profit. A PLI is a measure of a company's profitability that is used to compare comparables with the tested party. A PLI may express profitability in relation to (i) sales, (ii) costs or expenses or (iii) assets. More specifically, the PLI can be the operating profit relative to an appropriate base (e.g. costs, sales or assets). With the help of an appropriate profit level indicator the net profitability of the controlled transaction is compared to the net profitability of the uncontrolled transactions.

Table 4.T.6
Overview of Profit Level Indicators[38]

Return on Assets (ROA)	Operating profit divided by the operating assets (normally only tangible assets)
Return on Capital Employed (ROCE)	Operating profit divided by capital employed which is usually computed as the total assets minus cash and investments
Operating Margin (OM)	Operating profit divided by sales
Return on Total Costs (ROTC)	Operating profit divided by total costs
Return on Cost of Goods Sold	Gross profit divided by cost of goods sold
Berry Ratio	Gross profit divided by operating expenses

4.5.6.2 Key Definitions:

- **Gross profit** is arrived at by deducting from the total sales the cost of sales, including all the expenses directly incurred in relation to those sales;
- **Operating profit** or operating income is the income of a company net of direct and indirect expenses but before deduction for non-operating expenses such as interest and taxes. It is defined as sales minus COGS minus operating expenses (alternatively expressed as gross profit minus operating expenses). "Operating profit" is a better term than "net profit" in this context because net profit is also used to represent the profit of a company after interest and taxes have been subtracted. Further, the term operating profit indicates more clearly that only profits resulting from operating activities are relevant for transfer pricing purposes.

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38 Please note that not necessarily all PLIs mentioned can be used when applying the TNMM.

4.5.6.3 Although all of the above PLIs are possible, the three PLIs: (i) return on capital employed (ROCE), (ii) operating margin (OM) and (iii) return on total cost (ROTC) are most used in practice. The Berry Ratio may also be used, but subject to certain concerns about its inappropriate use.[39] An OM is typically used for marketing, sales and distribution activities; a Berry Ratio may sometimes be used for service or distribution activities; and full cost plus, ROCE or ROA are typically used for manufacturing activities. The ROA and ROCE divide operating profit by a balance sheet figure. These PLIs are based on assets actively employed in the business. Such tangible assets consist of all assets minus investments (e.g. in subsidiaries), minus cash and cash equivalents beyond the amount needed for working capital. In the case of the ROA a deduction is also made for intangible assets such as goodwill. These two PLIs may, for example, be used for leasing companies. This type of PLI may be the most reliable if the tangible operating assets have a high correlation to profitability. For example, a manufacturer's operating assets such as property, plant and equipment could have more impact on profitability than a distributor's operating assets, since often the primary value-added by a distributor is based on services it provides and these are often less dependent on operating assets. The difference between the ROA and the ROCE is that the ROA focuses on the assets used or contributed while the ROCE focuses on the amount of debt and equity capital that is invested in the company.

4.5.6.4 Other PLIs listed above are ratios between income statement items. PLIs based on income statement items are often used when fixed assets do not play a central role in generating operating profits. This is often the case for wholesale distributors and service providers. Operating margin has often been used when functions of the tested party are only broadly similar but not close to those of the comparables, since differences in function have less effect on operating profit than on gross profit.

4.5.6.5 The Berry Ratio represents a return on a company's value-added functions on the assumption that these value-added functions are captured

[39] For the Berry Ratio to be the most appropriate transfer pricing method to determine the remuneration of a controlled transaction (for instance for the distribution of products) the following elements have to be present: (i) the value of the functions performed, taking into account assets used or contributed and risks assumed, should be proportional to the operating expenses; (ii) the value of the functions performed, taking into account assets used or contributed and risks assumed, is not materially affected by the value of the products distributed; in other words it is not proportionate to sales; and (iii) the tested party does not perform other significant functions in the transaction under examination that should be remunerated using another method or profit level indicator.

in its operating expenses. It has been observed in practice that the Berry Ratio is used as a PLI for distributors and service providers. The Berry Ratio assumes that there is a relationship between the level of operating expenses and the level of gross profits earned by distributors and service providers in situations where their value-added functions can be considered to be reflected in the operating expenses. Consequently, it may be appropriate to use the Berry Ratio if the selling or marketing entity is a service provider entitled to a return on the costs of the provision of its services. It should be noted, however, that the Berry Ratio is very sensitive to functions and cost classification. The Berry Ratio has other limitations, including that it tends to only work if the comparables are functionally similar; and the comparables do not own significant intangible assets.

4.5.6.6 In general, the gross margin has not been favoured as a PLI because the categorization of expenses as operating expenses or cost of goods sold may be somewhat arbitrary or even subject to manipulation, making comparisons between the tested party and comparables difficult or impossible.

4.5.6.7 The choice of PLI depends on the facts and circumstances of a particular case. Thus, it may be useful to consider multiple PLIs. If the results tend to converge, that may provide additional assurance that the result is reliable. If there is, on the other hand, a broad divergence between the different PLIs it may be useful to examine important functional or structural differences between the tested party and the comparables.

4.5.7 Transactional Comparison Versus Functional Comparison

4.5.7.1 The arm's length (range of) net profit margins can be determined by way of:

- Transactional comparison: the net profit margin that the tested party enjoys in a comparable uncontrolled transaction which initially has been rejected as an internal comparable under the CUP Method due to its strict requirements; and
- Functional comparison: the net profit margins enjoyed by independent companies performing functions and assuming risks comparable to those of the tested party.

4.5.7.2 Much more detailed information will be available with respect to the controlled and uncontrolled transactions if a transactional comparison is possible, because the related parties involved have participated in these transactions. The degree of comparability can then be analyzed more thoroughly than in a functional comparison in which only public information is available (e.g. business descriptions in a database, annual reports and Internet data). This may imply that the reliability of transactional comparisons will be higher than that of functional comparisons in practice. In fact, if sufficient data exist to reliably apply a TNMM based on a transactional comparison it may be possible to apply a traditional transaction method.

4.5.7.3 However, functional comparison will be more often used in practice as the data necessary for functional comparison may be available whereas the data needed for transactional comparison is not. Let us assume that a related party distributor is the tested party in the example presented in Table 4.T.7. The TNMM is applied and the profit level indicator is the operating margin. A benchmarking analysis is performed, identifying four comparable independent distributors considering the comparability standard of the TNMM. The arm's length range of operating margin earned by these comparable distributors falls between 2 per cent and 6 per cent. Because the operating profit margin earned by the related party distributor falls within this range (e.g. 4 per cent), its transfer price is considered to be at arm's length.

Table 4.T.7
Functional Comparison Example

	Comparable A	**Comparable B**	**Comparable C**	**Comparable D**	**Tested Party**
Revenue	100 000	120 000	125 000	130 000	122 000
COGS	80 000	92 400	95 000	89 700	92 720
Gross profit	20 000	27 600	30 000	40 300	29 280
Operating expenses	18 000	24 000	25 000	32 500	24 400
Operating profit	2 000	3 600	5 000	7 800	4 880
Operating profit margin	2%	3%	4%	6%	4%

4.5.8 Comparability

4.5.8.1 Product comparability is most important in applying the CUP Method, as differences in products will result in different prices. The CPM and the RPM are less dependent on product comparability and focus on functional comparability because differences in functions that are reflected in differences in operating expenses may lead to a broad range of gross margins. However, the TNMM is even less dependent on product comparability and functional comparability than the traditional transaction methods, because net margins are less influenced by differences in products and functions. The TNMM focuses on broad product and functional comparability.

4.5.8.2 However, the comparability standard to be applied to the TNMM requires a high degree of similarity in several factors between the tested party and the independent enterprises that may adversely affect net margins. Net margins may be affected by factors that have no effect, or a less significant effect, on gross margins or prices due to the variation of operating expenses between companies. These factors may be unrelated to transfer pricing.

4.5.8.3 Specific factors that may affect net margins include, but are not limited to:

- Barriers to entry in the industry;
- Competitive position;
- Management efficiency;
- Individual business strategies;
- Threat of substitute products;
- Varying cost structures (e.g. the age of plant and equipment); and
- The degree of business experience (e.g. start-up phase or mature business).

If material differences between the tested party and the independent enterprises are affecting the net margins, reasonably accurate adjustments should be made to account for such differences.

4.5.9 Other Guidance for Application of the Transactional Net Margin Method

4.5.9.1 The TNMM is less reliable when applied to the aggregate activities of a complex enterprise engaged in various different transactions or functions. The method should be used to analyze only the profits of the associated enterprise that are attributable to simpler controlled transactions or functions. The TNMM should thus generally not be applied on a company-wide basis if the company is involved in a number of different controlled transactions or functions which are not properly evaluated on an aggregate basis. However, it may be possible to apply the TNMM when the aggregate activities/transactions are sufficiently interlinked, as for example when similar sales functions are conducted for products in similar product lines.

4.5.9.2 The TNMM should be applied using transactions or functions of independent enterprises that are comparable to the controlled transactions or functions being examined. Furthermore, results attributable to transactions between the tested party and independent enterprises should, if possible, be excluded when evaluating controlled transactions. The latter point is illustrated in Table 4.T.8. below. In this example, the Related Party Distributor purchases products from both the Related Party Manufacturer and an Unrelated Manufacturer and resells these products to customers. The tax authorities in the country of the Related Party Distributor apply the TNMM to determine whether the transfer prices of the Related Party Distributor are at arm's length. A benchmarking study performed by the tax authorities shows that comparable distributors earn an operating profit margin between 2 and 6 per cent.

4.5.9.3 The tax authorities initially apply the TNMM to the profit and loss statement (P&L) of the Related Party Distributor as a whole. The operating profit margin earned by Related Party Distributor is 2 per cent based on aggregate transactions and therefore falls within the arm's length range. The aggregated transactions therefore appear to be at arm's length leading to a preliminary conclusion that no transfer pricing adjustment is required. However, if the TNMM was applied only to the results of the distributor from the resale of products acquired in controlled transactions, the conclusions would be very different. The operating profit margin earned by Related Party Distributor on its resale of the products acquired in the controlled transactions is minus 3 per cent, which falls outside the arm's length range of comparable operating profit margins and therefore appears to merit an adjustment. It appears from the P&L that in this example the resale of products acquired by Related Party Distributor in controlled transactions generated operating losses, which reduced the aggregate income of the distributor as a whole. Consistency is important in quantifying these amounts. Net margins should be calculated uniformly between the tested party and the independent enterprises.

Table 4.T.8

Specific Transactions Versus Company as a Whole

	Controlled Transactions	Uncontrolled Transactions	Aggregate Transactions
Sales	$100 000	$100 000	$200 000
COGS	90 000	78 000	168 000
Gross profits	10 000	22 000	32 000

Table 4.T.8 (continued)

	Controlled Transactions	Uncontrolled Transactions	Aggregate Transactions
Operating expenses	13 000	15 000	28 000
Operating profit	(3 000)	7 000	4 000
Operating profit margin	- 3%	7%	2%

4.5.9.4 An analysis considering multiple year data is sometimes better able to take into account the effects on profits of product life cycles and short-term economic conditions. Different countries may take different views about when multiple year data should be analyzed and indeed whether that is allowed under a country's domestic law; see multiple year data analyses at the examples at 4.5.5.3 and 4.5.5.4. Use of an arm's length range should also be considered, to reduce the effects of differences between the controlled and uncontrolled entities. However, the use of a range may not sufficiently take into account circumstances where the profits of a taxpayer are affected by a factor unique to that taxpayer.

4.5.10 Strengths and Weaknesses of the Transactional Net Margin Method (TNMM)

4.5.10.1 The strengths of the TNMM include the following:

- Net margins are less affected by transactional differences than price and less affected by functional differences than gross margins. Product and functional comparability are thus less critical in applying the TNMM;
- Less complex functional analysis is needed, as the TNMM is applied to only one of the related parties involved;
- Because the TNMM is applied to the less complex party, it can be used even though one of the related parties holds intangibles for which comparable returns cannot be directly determined;
- The TNMM is applicable to either side of the controlled transaction (i.e. to either the related party manufacturer or the distributor); and
- The results resemble the results of what could be referenced as a modified RPM or CPM of analysis.

4.5.10.2 The weaknesses of the TNMM include the following:

- Net margins are affected by factors (e.g. variability of operating expenses) that do not have an effect, or have a less significant effect, on price or gross margins. These factors affect net profits and hence the results of the TNMM but may have nothing to do with the company's transfer pricing. It is important to consider these (non-pricing) factors in the comparability analysis;

- Information challenges, including the unavailability of information on profits attributable to uncontrolled transactions;
- Measurement challenges, as these may make it difficult to determine sales revenue, operating expenses and assets relating only to the relevant controlled transactions or functions in order to calculate the selected profit level indicator. For example, if a related party distributor purchases products from both a related party and an unrelated enterprise for resale it may be impossible to determine sales revenue, operating expenses and assets attributable to only the controlled transactions to reliably perform a net margin method of analysis. Furthermore, if the companies are engaged in different activities it may also be very difficult to allocate sales revenue, operating expenses or assets between the relevant business activity and other activities of the tested party or the comparables. This measurement problem is an important consideration in practice;
- The TNMM is applied to only one of the related parties involved. The arm's length net margin found may thus result in an extreme result for the other related parties involved in the controlled transaction (e.g. operating losses to one of the parties while the other party is guaranteed a net profit). This weakness also applies to the CPM and RPM but may be more important under the TNMM because net margins are affected by factors that may have nothing to do with transfer pricing. A check of the results of all related parties involved may therefore be appropriate;
- It may be difficult to "work back" to a transfer price from a determination of the arm's length net margins; and
- Some countries do not recognize the use of TNMM. Consequently, the application of TNMM to one of the parties to the transaction may result in unrelieved double taxation when the results of the TNMM analysis are not accepted for the other party.

4.5.11 When to Use the Transactional Net Margin Method (TNMM)

4.5.11.1 TNMM is usually applied with respect to broad comparable functions rather than particular controlled transactions. Returns to these functions are typically measured by a PLI in the form of a net margin that may be affected by factors unrelated to arm's length pricing. Consequently, one might expect the TNMM to be a relatively disfavoured method. Nevertheless, TNMM is often applied when two related parties engage in a continuing series of transactions and one of the parties makes a less complex and more routine contribution to profits than does the other. In fact, it has become the most commonly applied transfer pricing method in cross-border disputes, largely because of the unavailability of good transactional comparables in many circumstances.

4.5.11.2 TNMM may also be appropriate for use in certain situations in which data limitations on uncontrolled transactions make it more reliable than traditional methods. TNMM may be more attractive if the data on gross margins are less reliable due to accounting differences (i.e. differences in the treatment of certain amounts as cost of goods sold or operating expenses) between the tested party and the comparable companies for which no adjustments can be made as it is impossible to identify the specific costs for which adjustments are needed. In such a case, it may be more appropriate to use TNMM to analyze net margins, a more consistent measured profit level indicator than gross margins in case of accounting differences.

4.5.11.3 Consider the example in Table 4.T.9. below, where the related party distributor earns a gross profit margin of 20 per cent while the comparable distributor earns a gross profit margin of 30 per cent. Based on the RPM one could conclude that the transfer price of the related party distributor is not at arm's length. However, this conclusion may be incorrect if, due to accounting inconsistency, the related party differs from the comparable distributor in allocating costs between cost of goods sold and operating expenses.

4.5.11.4 For example, it may be the case that the related party distributor treats warranty costs as cost of goods sold while the comparable distributor treats such costs as operating expenses. If the warranty costs of the comparable distributor can be identified precisely, then appropriate adjustments on the gross profit level can be made. In practice, however, such detailed information about independent enterprises cannot be obtained from publicly available information. It may then be more appropriate to perform a net margin method of analysis where such accounting inconsistency has been removed. The result of applying the TNMM is that the net profit margin of 10 per cent for the related party distributor is similar to that of the comparable distributor. The transfer price is therefore considered to be at arm's length based on the TNMM.

4.5.11.5 Also, if the available comparables differ with respect to products and functions, making it difficult to reliably apply the CPM or RPM at gross profit level, it may be more appropriate to apply the TNMM (at operating profit level) because net margins are generally less affected by such differences. For example, in performing a benchmarking analysis for the purposes of the CPM or RPM it may appear that exact product and functional comparables cannot be found. In fact, the comparables differ substantially regarding product and functional comparability. In such a case the TNMM might be more reliably applied using such comparables.

4.5.11.6 Finally, TNMM may be attractive if the data are simply not available to perform a gross margin method of analysis. For example, this may be the case if the gross profits of comparable companies are not published and only their operating profits are known. The cost of goods sold by companies may also not be available, therefore only a net margin method of analysis can be applied.

4.5.11.7 In addition to the three situations mentioned above, the TNMM is also used in practice by tax authorities to identify companies for an audit by analyzing their net profit margins. Furthermore, the TNMM is often applied to check and to confirm the results of traditional transactional methods. For example, the TNMM may be used in combination with the RPM to determine an arm's length compensation for a distribution company.

Table 4.T.9
Accounting Differences: The Resale Price Method (RPM) as Compared with the Transactional Net Margin Method (TNMM)

	Related Party Distributor	Comparable Distributor
Selling price	100	100
Cost of goods sold	80	70
Gross profit	20	30
Operating expenses	10	20
Operating profit	10	10

4.6 Transactional profit methods: Profit Split Method (PSM)

4.6.1 Introduction to PSM

4.6.1.1 Transactional profit methods analyze the profits arising from particular controlled transactions in order to determine whether the transfer price is at arm's length. Transactional profit methods can be divided into two categories; the Transactional Net Margin Method (TNMM) and the Profit Split Method (PSM). This section covers the PSM.

4.6.1.2 The PSM is a useful, but often complex method of determining transfer prices based on an allocation of the relevant, combined profits made by the related parties in relation to the transaction(s).

4.6.1.3 The PSM seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that it is appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions.

4.6.1.4 The PSM may be appropriate where:

- each related party to the transaction makes unique and valuable contributions; and/or
- the business operations of the related parties are so highly integrated that they cannot be reliably evaluated in isolation from each other; and/or
- the parties share the assumption of economically significant risk or separately assume closely related risks.

See section 4.6.3 et seq.

4.6.1.5 The PSM starts by identifying the relevant profits, or indeed losses in relation to the controlled transactions. It then seeks to split those profits or losses between the associated enterprises involved on an economically valid basis in order to achieve an arm's length outcome for each party. Typically, the split should reflect the relative value of each enterprise's contribution, including its functions performed, risks assumed and assets used or contributed.

4.6.1.6 The PSM is also referred to as the transactional PSM. It can be distinguished from global formulary apportionment approaches in the following ways. The PSM typically does not start with the global or total combined profits of the entire MNE group. Rather, it begins from the relevant profits in relation to particular transactions between two or more associated enterprises. Moreover, in order to comply with the arm's length principle, the way in which the method is applied should not be arbitrary, but rather should approximate the results achieved had the parties been independent of each other. In particular, the factors by which the relevant profits are split between the associated enterprises to the transaction are typically based on measures of their relative contributions to value creation rather than an arbitrary formula.

4.6.2 Strengths and Weaknesses of the Profit Split Method

4.6.2.1 The strengths of the PSM include:

- It can provide a solution in cases where one-sided methods are not appropriate because each party to the transaction makes a unique and valuable contribution which cannot be benchmarked;
- It can be used where the level of integration, or the sharing of risks between the related parties means that the contribution of each party cannot be evaluated in isolation from those of other parties;
- As it is a two-sided method, all relevant parties to the transaction are directly evaluated, helping to ensure an arm's length result for each entity based on the relative value of its specific contributions, even in cases where there may be specific or unique facts and circumstances which may not be present in transactions between independent enterprises; and
- It is able to deal with returns to synergies between contributions or profits arising from economies of scale.

4.6.2.2 The weaknesses of the PSM include:

The PSM is often complex to apply. It may be difficult to measure the relevant revenues and costs to be split between the related parties. In addition to measurement difficulties, the method is typically highly reliant on detailed data from the MNE (see also Chapter 12 of this Manual, which deal with transfer pricing documentation). Determining an appropriate way to split the profits can also be challenging. Care must be taken to ensure the application of the PSM is as objective as possible. Since reliable, direct information on the allocation of profits in comparable independent transactions is relatively rare, the PSM often relies on less direct information or proxies (e.g. relative value of the contributions of each party) in its application of the arm's length principle.

4.6.3 When to Use the Profit Split Method (PSM)

4.6.3.1 As with any transfer pricing method, the profit split should be used where it is found to be the most appropriate method to the circumstances of the case. Primarily, this determination is based on the nature of the accurately delineated transaction in the context of its circumstances. The analysis to determine the accurately delineated transaction should consider the commercial and financial relations between the related parties, their functions performed, assets used or contributed, and risks assumed, and how the activities of the parties impact the transaction given the market context in which the transaction occurs.

4.6.3.2 While as noted above, the PSM can be a complex method to apply reliably, the determination of when it is the most appropriate method should be done as objectively as possible. That is, the PSM should not simply be regarded as a method of last resort. Moreover, while the method may require relatively more, or more detailed information from the taxpayer and its associated enterprise(s) than other methods, where it is indeed found to be the most appropriate method, reasonable efforts should be made to gather such necessary information which, after all, will typically be in the hands of the MNE.

4.6.3.3 While it is not possible to be prescriptive, as noted above, indicators that a profit split may be the most appropriate method include:

- Where each related party to the controlled transaction makes a unique and valuable contribution; and/or
- Where the business operations of the related parties are so highly integrated that the contributions of the parties cannot be reliably evaluated in isolation from each other; and/or
- Where the related parties either share the assumption of the key economically significant risks associated with the transaction(s), or separately assume closely related economically significant risks associated with the transactions.

4.6.3.4 The presence of any one or more of these indicators suggests that the profit split may be the most appropriate method.

4.6.3.5 Where one or more of the above indicators is present, it is highly unlikely that reliable comparable transactions will be available. However, a lack of comparables per se is insufficient evidence to conclude that a profit split will be the most appropriate method. That is, the PSM should not become a convenient method to be applied in every case where close comparables cannot be identified.

4.6.3.6 In contrast, where none of the indicators are present and the accurate delineation of the transaction shows that one of the related parties to the transaction performs functions, uses or contributes assets and assumes risks that can be reliably benchmarked by reference to uncontrolled comparables, a profit split is unlikely to be the most appropriate method. In such cases, it is likely to be more reliable to apply a transfer pricing method making use of the uncontrolled comparables, even in cases where ‘perfect’ or closely comparable uncontrolled transactions are lacking (see 4.1.2.9). As with any other method, pricing practices used between independent parties engaged in similar transactions in the same industry or market can provide information relevant to the analysis of the most appropriate transfer pricing method.

4.6.3.7 It is sometimes argued that since the PSM is seldom used among independent enterprises, its application in controlled transactions should be similarly rare. Whether or not the premise of this argument is correct, where the method is found to be the most appropriate to the circumstances, this should not be a factor. Transfer pricing methods, including the PSM, are not necessarily intended to replicate the way in which independent parties establish prices among themselves; rather, they are a way in which the arm's length principle can be applied in order to determine appropriate transfer prices in controlled transactions. That said, if there is evidence (e.g. from a joint venture or similar arrangement) that independent parties in comparable circumstances use a PSM among themselves, this may suggest that a profit split will also be the most appropriate method in relation to the controlled transactions.

Unique and Valuable Contributions by Each Party

4.6.3.8 Perhaps the clearest indicator that the PSM may be the most appropriate method involves situations in which each party to the controlled transaction makes unique and valuable contributions. Such contributions (e.g. functions performed, assets used or contributed, including intangibles) will be "unique and valuable" where:

(i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances; and

(ii) they represent a key source of actual or potential economic benefits in the business operations.

Together, these factors mean that the application of other transfer pricing methods may not be capable of reliably determining an arm's length outcome because neither related party can be reliably benchmarked by reference to comparables.

4.6.3.9 When evaluating whether certain contributions are unique and valuable such that a PSM may be the most appropriate, a consideration of the context of the transaction, including the industry and market in which it occurs and the factors which affect business performance in that context are particularly relevant. See section 6.2.2 et seq. in relation to unique and valuable intangibles. See also section 6.3.4.2 in relation to transfers of fully developed intangibles and section 6.5.4 in relation to transfers of partially developed intangibles or intangibles whose future profit potential is very uncertain.

4.6.3.10 **Example — Unique and Valuable Intangibles**

Example: Company A and Company B each Contribute a Unique and Valuable Intangible

Company A, a resident of country A has developed, by its own efforts, a trademark and associated brand for an over-the-counter seasonal hay fever medicine, "Seritum". The Seritum trademark and brand are well known throughout the A-B region. The trademark and reputation of the brand allows Company A to charge a premium for Seritum hay fever medicine over the chemically equivalent generic product.

Company B, an associated enterprise of Company A resident in country B, has developed, by its own efforts, a version of the generic hay fever medicine that is also effective for other allergies, such as those triggered by cats and dogs. This modification is sufficiently different and innovative that B has been granted a patent for its modified compound. Clinical trials conducted on the modified compound show it to be safe and effective, and to provide symptomatic relief for people allergic to cats and dogs, as well as seasonal hay fever.

Company A enters into an agreement with Company B to market the modified allergy medicine under the trademark "AllSeritum" in the A-B region. A marketing strategy is devised and a campaign undertaken by Company A to market the new product in region A-B based on the familiarity of the "Seritum" brand as well as the expanded application and efficacy of the new product.

AllSeritum turns out to be highly successful. It can access a previously untapped market for allergy medicines; the pharmacological compound has the benefit of patent protection for the following 10 years; and customers were already familiar with and trusted the Seritum brand.

In this case the most appropriate method is determined to be a profit split method since both A and B make unique and valuable contributions: the unique and valuable trademark and associated brand in the case of A, and the unique and valuable patent in the case of B.

4.6.3.12 Example — Material But Not Unique and Valuable

Example: Unique and Valuable DAEMPE Functions

Dades Enterprises, a resident of country G is in the business of software development and provides tailored software solutions to customers. Dades Enterprises has developed certain proprietary software relating to 3D mapping of underground aquifers. Subsequently, Dades Limited, a resident of country I and a member of the same MNE as Dades Enterprises, enters into an agreement with Client M, an independent party, for the supply of similar software, tailored to the mapping of underground liquid hydrocarbons. Dades Enterprises provides Dades Limited with access to the relevant code, software designs and know-how developed in the original project. The legal agreement between the entities states that Dades Enterprises will retain legal ownership in any and all resulting software based on the original product.

Dades Limited engages its own engineers to further develop and enhance the original software. The resulting product is largely based on the original proprietary software developed by Dades Enterprises, but contains material enhancements.

The transfer pricing analysis shows that both Dades Enterprises' and Dades Limited made unique and valuable contributions to the development of the enhanced software developed for Client M. Dades Enterprises' contribution was in the form of the unique and valuable proprietary software, and Dades Limited in the form of unique and valuable contributions to the development and enhancement of that software. As a result of this, the profit split is determined to be the most appropriate method in this case.

DAEMPE Functions

Example: Material But not Unique and Valuable DAEMPE Functions

The facts are the same as in 4.6.3.11 above, except that the development and enhancement activity conducted by Dades Limited is less significant and relates only to enhancing the original proprietary software so that it accepts a wider range of data input formats. In this case, the contribution of Dades Limited is found not to be unique and valuable, and as a result, a one-sided method is likely to be the most appropriate way of determining an arm's length price for the transaction.

Highly Integrated Operations

4.6.3.13 All MNEs have business operations which are integrated to some degree. However the PSM is likely to be the most appropriate method only in those cases where the integration is so significant that the way in which each party performs functions, uses assets, and assumes risks is interlinked with and cannot be reliably evaluated in isolation from the way in which another related party to the transaction performs functions, uses assets and assumes risks.

4.6.3.14 One example of highly integrated operations which may warrant the determination that the profit split is the most appropriate method could be where the related parties perform functions jointly, use common assets jointly and/or share the assumption of economically significant risks, and do so to such an extent that their respective contributions cannot be evaluated in isolation.

4.6.3.15 Another example may be where the integration between the related parties takes the form of a high degree of inter-dependency. For instance, a profit split may be found to be the most appropriate method where, under a long-term arrangement, each party has made a significant contribution (e.g. of an asset) whose value depends in large degree on the other party. In such cases, a profit split approach could allow for pricing which appropriately takes into account and varies with the outcome of the risks assumed by each party.

4.6.3.16 **Example — Significant Integration**

Stefanelli Enterprises Inc (SEI), incorporated in country M and Stefanelli Enterprises Corporation (SEC), a resident of country N are members of an MNE group specializing in providing trade facilitation for agricultural commodities and bulk chemicals. The prices for the products themselves are largely determined based on exchange-quoted prices. Stefanelli's customers may be either suppliers or purchasers of the products and tend to operate in both country M and country N. Customers expect the same standard of service in both countries and rely on the integrated nature of Stefanelli's operations in each country to provide a seamless service in moving products from and to the two countries. Customers contract with either SEI or SEC depending on the country in which the trade originates. Functions associated with marketing and customer relations are undertaken by SEI or SEC, depending on the location of the customer. A functional analysis shows that SEI and SEC perform similar activities in fulfilling customer contracts, including arranging transportation and warehousing where required, as well as facilitating customs clearance in the exporting and importing countries, irrespective of which enterprise holds the contract with the customer. Therefore, both SEI and SEC support each other and provide services to one another in fulfilling their respective contracts. SEI or SEC may also source supplies for buyers or seek out customers on behalf of suppliers, but they do not take positions on the purchase and sale of the products on their own account. Instead, they either act as an agent, or enter into simultaneous purchase and sale agreements.

SEI and SEC perform a similar range of functions and must cooperate extremely closely in order to effectively and efficiently provide services to the group's customers. The two entities jointly use and contribute to the further development of the group's economically significant assets, being its know-how, customer and supplier relationships, and its IT systems. The group markets itself to customers based on its efficiency and ability to provide seamless, integrated services in both countries M and N.

Although market data exists about fees charged for trade facilitation services, it is found that the level of integration between SEI and SEC is so significant that their operations cannot be reliably evaluated in isolation from each other. As a result, the profit split is determined to be the most appropriate method in this case.

4.6.3.17 **Example — Complementary But Discrete Activities**

Schol Manufacturing, a resident of country A, is a fully-fledged manufacturer of plastic products for the food service industry. Schol Distribution, an associated enterprise of Schol Manufacturing located in country B, imports these products and distributes them in the local market to food processing companies, restaurants, caterers, retail food outlets etc. Schol Distribution only purchases products from Schol Manufacturing and is wholly dependent on the latter for its supply of products. Schol Distribution provides customer feedback to Schol Manufacturing, but does not otherwise participate in the design or production process. A functional analysis shows that Schol Distribution does not make any unique and valuable contributions. For instance, it has not developed a highly valuable trademark or tradename for the plastic products in the market.

Schol Manufacturing is also highly dependent upon Schol Distribution since it does not have any sales or distribution functions in country A. Without Schol Distributions, it would find it very difficult to sell its products into the country A market.

While Schol Manufacturing and Schol Distribution are highly dependent upon each other, an appropriate arm's length remuneration for each of them can be determined without the need to consider their activities together. For example, the distribution activities of Schol Distribution might be able to be reliably benchmarked through the application of the transactional net margin method and looking to comparable uncontrolled distributors. In this case therefore, the profit split is unlikely to be the most appropriate method.

Shared Risks

4.6.3.18 A further indicator that the profit split may be the most appropriate method is where the parties to the controlled transaction share the assumption of the economically significant risks in relation to the transaction (see 14.4.4.). It may also be the most appropriate method in cases where the parties separately assume risks that are so closely related or inter-linked that the playing out of the risks of each party cannot be reliably isolated from the risks assumed by the counterparties.

4.6.3.19 The relevance of risk-sharing to the determination of the most appropriate transfer pricing method will depend greatly on the extent to which the risks concerned are economically significant such that each party should be entitled to a share of the relevant profits associated with the controlled transaction(s) had the transaction occurred at arm's length.

4.6.3.20 **Example — Shared Assumption of Risks**

Global trading of financial instruments often occurs under an integrated trading model where each enterprise or location within the MNE performs the full range of trading and risk management functions. That is, the entities comprising the MNE jointly perform the same key functions, use the same key assets and assume the same economically significant risks. Moreover, each enterprise or location cannot act independently and instead must co-operate with others in order to successfully enter into transactions and manage and control the risks related to those transactions.

Bank B operates as a global trader of financial instruments. The headquarters of the bank has a number of subsidiaries and branches around the world which underwrite and distribute financial products, act as market-makers in securities and derivative instruments and perform brokerage functions for clients trading on stock and commodities exchanges around the world. As a result of these activities, Bank B mainly earns income in the form of interest and dividends from the inventories it holds to be a market-maker on physical securities, (net) gains on the trading of financial instruments, income from derivatives and fees from clients.

Bank B operates its global trading business using an integrated trading model. That is, traders in each of its main trading centres in countries X, Y and Z (each of which is in a time zone which is at least five hours different from the other) set prices and trade off a portfolio of positions (the "book") while the market is open in that country. When the markets in a particular country close, responsibility for trading the book is passed on to the main trading centre in the next time zone. Traders in each main trading centre have full control over the book and may close positions passed to them and open new ones. However, the legal ownership of the book does not change with the handover in control. The overall parameters and limits for allowable trades are set by a committee which comprises roughly equal numbers from each of the main trading centres, however, in each location, traders enter into transactions with customers based on their own professional decision making. The functional analysis shows that the main trading centres in countries X, Y and Z use the assets of the business jointly, and they jointly assume the economically significant risks. Each trading location undertakes broadly the same functions or activities and must cooperate with the others in order to successfully undertake their business and manage and control the risks associated with those transactions.

Significant additional efficiencies and profit opportunities arise from the ability of Bank B to trade its book on a 24-hour basis. Traders in each location receive a base salary together with performance pay based on a share of a bonus pool determined according to the overall profitability of the book.

In this example, the main trading centres, through their close co-operation and joint performance of activities, share the assumption of the economically significant risks. As a result, the profit split method is found to be the most appropriate method.

Availability of Information

4.6.3.21 It will often be the case that where the profit split is found to be the most appropriate method, direct comparable transactions that may otherwise be used to price the transaction will not be found. However, information from uncontrolled transactions may still be relevant to the application of the PSM, for example in terms of the how the relevant profits should be split amongst the parties, or in the first part of a residual profit split. See 4.6.5.10 et seq. and 4.6.4.7, respectively; see also section 4.6.3.6 on the relevance of market information.

4.6.4 How to Apply the Profit Split Method (PSM)

4.6.4.1 As was noted at the beginning of this section, in general, a PSM first determines the relevant profits, being the total profits in relation to the controlled transactions under examination, and then splits those profits on an economically valid basis. There are a number of different approaches as to how those relevant profits are allocated between the associated enterprises, including the contribution and residual analysis approaches. These are discussed in more detail below.

4.6.4.2 As with all transfer pricing methods, care should be taken to avoid the use of hindsight in the application of the PSM (see section 4.6.5.10). In general, where it is found to be the most appropriate method, the PSM should be applied consistently to transactions over time, irrespective of the amount of the relevant profits (or indeed if there are losses). Applications of the method which vary depending on the amount of the relevant profits may be found to be arm's length in some cases, but would be less common. If there are significant unforeseen developments which would have resulted in a renegotiation of the agreement between the parties had they been at arm's length, a different application (going forward) may be warranted. For example, a different way of determining the relevant profits or how to split them might be agreed. In such cases, documenting the reasons for the different application would be essential.

4.6.4.3 When applying or evaluating the use of the PSM it is important to ensure that the complexity of the process does not result in losing sight of the intended result: an arm's length outcome for each related party involved. In some cases therefore, particularly where the process relies on multiple assumptions or complex calculations, it may be useful to perform a 'reality check' of the outcomes using alternative methods or means.

4.6.4.4 There are several ways in which the PSM can be applied.

Contribution Analysis

4.6.4.5 Under a contribution analysis, the relevant profits are allocated between the associated enterprises engaged in the controlled transactions in a way that aims to reflect a reasonable approximation of the divisions that would have been agreed by independent enterprises in similar circumstances. Relevant external market data, i.e. from comparable independent transactions between unrelated enterprises or between the taxpayer and an unrelated enterprise, should be used to support this allocation where available. However more commonly, such external data will not be obtainable. In such cases, the arm's length principle can be applied by using data internal to the taxpayers themselves to determine the relative value of the contributions of each party to the controlled transaction(s). For example, this might be done by comparing the nature and degree of each party's contributions to the controlled transactions and assigning a percentage based on that relative comparison (and any external market data that may be available).

4.6.4.6 The way in which the value of such contributions is measured will depend on the facts of each case. The determination of appropriate profit splitting factors is discussed in more detail below (see section 4.6.5.10 et seq). Note that if the relative value of the contributions can be determined, then calculating the actual value of the contribution of each enterprise may not be required.

Residual Analysis

4.6.4.7 While a contribution analysis takes the relevant profits in relation to the transaction and splits them between the parties in a single step, the PSM can be applied using a staged approach under a residual analysis. Such an approach is likely to be appropriate where one or more parties to the controlled transaction(s) makes a contribution(s) which is routine and could be benchmarked based on comparables.

4.6.4.8 Step 1: allocation of an arm's length profit to each enterprise to compensate it for its routine or benchmarkable contributions. Typically this is done by the application of one-sided transfer pricing methods such as the TNMM and consideration of the returns earned by independent enterprises engaged in activities which are comparable to those routine or benchmarkable contributions. In this first step, other contributions, such as those which are unique and valuable, are not taken into account. Each related party is allocated an appropriate 'routine' return from the pool of relevant profits.

4.6.4.9 Step 2: allocation of residual profit (i.e. remaining relevant profits after the Step 1 allocation) on an economically valid basis. In the second step, other contributions not already accounted for, including those which are unique and valuable, are considered. As was described above in relation to a contribution analysis, this allocation must be done on an economically valid basis, and aim to achieve a reasonable approximation of the divisions that would have been agreed by independent enterprises in similar circumstances. The second step allocation will thus typically consider the relative value of the contributions of each party to the residual profits, supplemented where possible by external market information on how independent parties would have divided such profits in similar circumstances.

4.6.4.10 As has been noted above, since reliable, direct information on how profits would have been allocated in comparable uncontrolled transactions might not be available, care is required in applying the PSM. The residual approach to the application of the method aims to reduce possible subjectivity by confining, to the extent possible, the more difficult step 2 allocation (which is typically not based directly on comparables data).

> Company X manufactures components using unique and valuable intangibles and sells these components to a related party, Company Y. Company Y then uses the components, together with its own unique and valuable intangibles, to manufacture final products, which it sells to independent customers. The first step of the residual analysis would allocate a basic, 'routine' or benchmarkable arm's length return to Company X for its manufacturing function, and a basic, 'routine' or benchmarkable arm's length return to Company Y for its manufacturing and distribution functions. The relevant profits from the transactions, less the amounts of the basic or 'routine' returns to Company X and Company Y, will be the residual profit. This residual profit is then split between the parties based on the relative value of their respective unique and valuable contributions. This second step of splitting the residual profits need not, and typically does not, depend on the use of comparables.

4.6.4.11 The following approaches have been specified in some jurisdictions to determine the relative value of each company's contributions of intangibles:

- External market benchmarks reflecting the fair market value of the intangible property;
- The capitalized cost of developing the intangibles and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible;[40] and

[40] A disadvantage of this approach is that cost may not reflect the market value of the intangible property. This example is intended simply to illustrate the mechan-

- ➢ The amount of actual intangible development expenditures in recent years if these expenditures have been constant over time and the useful life of the intangible property of all parties involved is broadly similar.

4.6.4.12 The residual approach is used more in practice than the contribution approach for two reasons. Firstly, the residual approach breaks up a complicated transfer pricing problem into two manageable steps. The first step determines a basic return for routine or benchmarkable functions based on comparables and the application of a one-sided method or methods. The second step analyzes returns to unique and valuable contributions or other elements which are un-benchmarkable. Rather than trying to determine absolute values for these contributions based on comparables, the method focuses on their relative value which may often be determined more reliably. Secondly, potential conflict with the tax authorities is reduced by using the two-step residual approach since it reduces the amount of profit that is to be split in the potentially more controversial second step.

4.6.4.13 **Example—Application of Residual Profit Split**

XYZ is a corporation that develops, manufactures and markets a line of products for use by the police in Country A. XYZ's research unit developed a bulletproof material for use in protective clothing and headgear (Stelon). XYZ obtains patent protection for the chemical formula for Stelon. Since its introduction, Stelon has captured a substantial share of the market for bulletproof material.

XYZ licensed its Asian subsidiary, XYZ-Asia, to manufacture and market Stelon in Asia. XYZ-Asia is a well-established company that manufactures and markets XYZ products in Asia. XYZ-Asia has a research unit that adapts XYZ products for the defence market, as well as a well-developed marketing network that employs brand names that it has developed.

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ics of the application of a residual approach under the profit split method. No inference should be drawn from this example as to the appropriateness of the profit splitting factors (or other parameters) to any superficially similar cases. In particular, the relative capitalized, amortized expenses of the intangibles may not always reflect the relative contributions to value made by the parties; where this is the case, an alternative means of evaluating those contributions will be required.

XYZ-Asia's research unit alters Stelon to adapt it to military specifications and develops a high-intensity marketing campaign directed at the defence industry in several Asian countries. Beginning with the Y1 taxable year, XYZ-Asia manufactures and sells Stelon in Asia through its marketing network under one of its brand names.

For the Y1 tax year XYZ has no direct expenses associated with the license of Stelon to XYZ-Asia and incurs no expenses related to the marketing of Stelon in Asia. For the Y1 tax year XYZ-Asia's Stelon sales and pre-royalty expenses are $500 million and $300 million, respectively, resulting in net pre-royalty profit of $200 million related to the Stelon business. The operating assets employed in XYZ-Asia's Stelon business are $200 million. Given the facts and circumstances, it is determined that a residual profit split is the most appropriate method and will provide the most reliable measure of an arm's length result. Based on an examination of a sample of Asian companies performing functions similar to the routine functions of XYZ-Asia it is determined that an arm's length return on XYZ-Asia's operating assets in the Stelon business is 10 per cent, resulting in a profit on those routine functions of $20 million (10% x $200 million) for XYZ-Asia's Stelon business, and a residual profit of $180 million.

Since the first stage of the residual profit split allocated profits to XYZ-Asia's contributions other than those attributable to unique and valuable intangibles, it is assumed that the residual profit of $180 million is attributable to the unique and valuable intangibles related to Stelon, i.e. the Asian brand name for Stelon and the Stelon formula (including XYZ-Asia's modifications). To estimate the relative values of these intangibles, the ratios of the capitalized value of expenditures as of Y1 on Stelon-related research and development and marketing over the Y1 sales related to such expenditures are compared.

As XYZ's protective product research and development expenses support the worldwide protective product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide business activities to which they relate. It is determined that it is reasonable to allocate the value of these expenses based on worldwide protective product sales. Using information on the average useful life of its investments in protective product research and development, XYZ's protective product research and development expenses are capitalized and amortized. This analysis indicates that the capitalized research and development expenditures have a value of $0.20 per dollar of global protective product sales in the Y1 tax year.

XYZ-Asia's expenditures on Stelon research and development and marketing support only its sales in Asia. Using information on the average useful life of XYZ-Asia's investments in marketing and research and development XYZ-Asia's expenditures are capitalized and amortized and from this it is determined that they have a value in Y1 of $0.40 per dollar of XYZ-Asia's Stelon sales.

Thus, XYZ and XYZ-Asia together contributed $0.60 in capitalized intangible development expenses for each dollar of XYZ-Asia's protective product sales for Y1, of which XYZ contributed a third (or $0.20 per dollar of sales) and XYZ-Asia contributed two thirds (or $0.40 per dollar of sales). Accordingly, it is determined that an arm's length split of the residual profits would see one third of those profits being allocated to XYZ and two thirds being allocated to XYZ-Asia.

Comparable Profit Split Method (PSM)

4.6.4.14 In some countries, reference is made to the Comparable PSM. This application of the PSM relies on a comparison of the allocation of profits between independent enterprises engaged in comparable activities under comparable circumstances to those of the controlled transaction(s). That is, it relies heavily on external market data to determine how the relevant profits should be split between the related parties. As has been noted above, such information may be very useful, but is rarely available in practice.

4.6.5 Determining the Profits to be Split

4.6.5.1 The relevant profits to be split under the PSM are those which arise to the associated enterprises as a result of the controlled transaction(s) under examination. It will be important to consider the level of aggregation of transactions in this regard (see 3.3.3.1 to 3.3.3.5) and then to examine the relevant income and expense amounts of each party in relation to those transactions.

4.6.5.2 In most cases, since the relevant profits will be comprised of income and expense amounts from more than one related party in more than one jurisdiction, the relevant financial data of the entities will need to first be put on a common basis, including with regard to the accounting practice and currency used. As this can materially affect the application of the method, consistency over time is important in this regard.

4.6.5.3 Other than in cases where the profit split covers all the activities of each of the related parties, the financial data will need to be segmented in accordance with the accurately delineated transaction(s) covered by the profit split approach. In cases where reliable product-line or divisional accounts are available, these may be useful to the determination of the relevant profits to be split.

Measures of Profit

4.6.5.4 The PSM is most commonly used to split net or operating profits. Applying the method in this way means that all the related parties are exposed to both the income and expenses associated with the relevant transactions in a consistent manner. However, depending on the accurate delineation of the transaction, other measures of profits may be appropriate. For own operating expenses. Such an application may be appropriate where the parties do not share the risks associated with the operating expenses relating to the controlled transaction, but do share the risks associated with the volume of sales and prices charged, as well as those associated with the production or acquisition of the goods or services.

Example: Measures of Profit

Accelory Corp designs, develops and manufactures complex industrial machinery products. A new generation of one of its key product lines uses an innovative powertrain system that was designed, developed and manufactured by TurboAcc Limited, an associated enterprise of Accelory. The system was tailored specifically for Accelory machines and would not be compatible with machines produced by other manufacturers without significant further modifications.

While Accelory Corp products are well established in the market and the company's products are considered to be market leaders in the sector, the innovative powertrain system developed by TurboAcc becomes a key selling point for the new generation of products. The success or otherwise of the new generation products relies to a significant degree on the performance of the powertrain systems made by TurboAcc.

The powertrain systems were developed entirely by TurboAcc. TurboAcc also assumed all of the risk in relation to the development of the systems, with no direct involvement by Accelory in the making of any significant decisions in this regard.

Accelory assumes all of the risks in relation to the overall production and sale of the new generation of products. In this example, although Accelory and TurboAcc each assume separate economically significant risks, those risks are highly interdependent. As a result, the profit split is found to be the most appropriate method. In this case, while the overall fortunes of the companies are highly interdependent, each company operates very independently and has no involvement in or control over the operations of the other. Therefore, a profit split of revenues from Accelory's sales of the product or the relevant gross profits of both Accelory and TurboAcc from the transactions may be the most appropriate way to apply the profit split method. In this way, each party will bear the financial consequences of the playing out of risks relating to their own operating expenses (and cost of sales in the case of a split of revenues).

Actual or Anticipated Profits

4.6.5.5 The PSM is most commonly applied to split the actual relevant profits of the related parties in relation to controlled transactions. Since actual profits will reflect the playing out of the risks which affect the transactions, such a split will typically result in each related party being subject to those risks. It would thus be appropriate where the accurate delineation of the transaction shows that each related party shares such risks. For example, where the parties to the controlled transaction share the assumption of the economically significant risks, or separately assume closely-related economically significant risks in relation to the controlled transactions, it would be expected that a split of actual profits would apply.

4.6.5.6 On the other hand, where the profit split is found to be the most appropriate method but the accurate delineation of the transaction shows that one or more of the related parties does not share in the assumption of the economically significant risks, a split of anticipated profits is likely to be more appropriate.

4.6.5.7 A common application of an anticipated profit split is in the use of a discounted cash flow valuation technique, which might be used, for example, to determine the present value of a transferred intangible or other asset. For example, Company A transfers all the rights in a fully developed unique and valuable intangible, intangible X, to Company B, its associated enterprise. Company B has its own unique and valuable intangibles which are expected to complement intangible X. Company A expects to have no ongoing involvement in the exploitation of intangible X, as these activities will be wholly undertaken and controlled by Company B. In this case, assume it is determined that the profit split is the most appropriate method since both Company A and Company B make unique and valuable contributions. However, since Company A will not be involved in the ongoing exploitation of the intangible after the transfer, and it does not assume any risks relating to those exploitation activities, at arm's length, its return should not be subject to those risks. Instead, it should receive a share of the anticipated profits from Company B's exploitation of the combined intangibles of Companies A and B, discounted to reflect its present value at the time of the transfer. This amount might be calculated using a discounted cash flow valuation technique which analyzes the present value of the likely income from the exploitation of intangible X. The ongoing risks relating to the exploitation of the intangibles are solely assumed by Company B and no adjustment to the remuneration due to Company A needs to be made should the intangible actually be more or less successful than anticipated.

4.6.5.8 It should be noted that measures of profits which vary to some degree with the playing out of risks, without being fully exposed to such risk, can also be used. In all cases, the measure of relevant profits to be split should be aligned with the accurate delineation of the transaction in order to produce an arm's length outcome.

4.6.5.9 Even where a profit split of actual profits is used, the method should be applied without hindsight. That is, unless there are significant unforeseen developments which would have resulted in a renegotiation of the agreement had it occurred between independent parties, the basis for determining how the relevant profits should be calculated and how they should be split amongst the associated enterprises should ordinarily be determined based on information known or reasonably foreseeable at the time of, or prior to the transaction(s). This is the case even though it may only be possible to apply the actual calculations some time thereafter. For example, Company E and its associated enterprise, Company F are so highly integrated that the PSM is found to be the most appropriate method to evaluate the controlled transactions between them. The way in which the relevant profits from their transactions should be determined is established ex ante, that is, at or prior to the time they engage in the transactions. At that time, they also determine that the residual PSM of actual net profits should be applied, and that the residual profits should be split between them on the basis of the value of current year marketing expenses of each party, after having allocated basic or 'routine' returns on the routine sales and distribution activities conducted by both Companies E and F. In this example, the way in which the PSM is to be applied is determined at the start of the period. However, the agreed method can only be applied at year end, once the amount of sales, marketing expenses, and the amount of the relevant actual net profits has been determined. If, in a subsequent period, these intragroup transactions are subject to a transfer pricing audit, the tax administration would not be precluded from examining the selection of the transfer pricing method or the way in which it was applied in order to confirm compliance with the arm's length principle. In doing this, the tax administration may also examine what information was actually known or reasonably foreseeable at the time of the transaction.

Profit Splitting Factors

4.6.5.10 The PSM aims to determine transfer prices by reference to the manner in which independent parties would have divided profits amongst themselves had they engaged in comparable transactions. However, information on comparable profit splits or similar arrangements is often not available, so the method is more often applied by reference to some other measure of the relative contributions to those profits of each associated enterprise, as a way of approximating the outcome that would have been achieved between independent parties.

4.6.5.11 It would not be appropriate to provide prescriptive guidance as to the measure or measures to be used to split the relevant profits, as this will depend on the facts of each case. However, whatever factor(s) are selected, they should be capable of objective measurement and not themselves subject to non-arm's length pricing or valuation. The measures should also be verifiable and supported by data. While these considerations need to be borne in mind, amounts based on the taxpayer's own internal information (e.g. from their financial accounts) are commonly used.

4.6.5.12 In some cases, a multi-factor approach to splitting profits may be adopted. However, it may also be the case that a single measure of the key contributions to value of each enterprise to the transaction will be sufficient as a proxy for the relative value contributed.

4.6.5.13 In this regard, information from the functional analysis is likely to be particularly important. Other information in the taxpayer's local file may also be useful. In addition, where the master file is available, the information therein on key value-drivers, considered in the context of the business and industry environment, may also be helpful to the extent that the value drivers for the transactions under examination are similar to those for the MNE or business line that is the subject of the master file.

4.6.5.14 Depending on the circumstances, profit splitting factors might be based on the value of (certain types of) assets or capital, where there is a strong correlation between tangible assets or intangibles, or capital employed, and the creation of value in the controlled transaction. In such cases, care should be taken to ensure reliable and consistent measures of the value of the asset(s) concerned.

4.6.5.15 In other cases, cost-based factors may be found to be appropriate, e.g. costs related to the unique and valuable contributions such as R&D, engineering, design, marketing, etc., or the development of unique and valuable intangibles. Note that although cost is often a poor measure of the absolute value of unique and valuable intangibles, the relative costs incurred by each party may provide a reasonable approximation of the relative value of their respective contributions. In some instances, it may be appropriate to adjust the cost amounts, e.g. where they are incurred in different periods, to ensure they represent reliable measures of the respective contributions of each party.

4.6.5.16 Other examples of profit splitting factors could include incremental sales, employee remuneration or bonus payments, time spent, headcount, etc. Such factors may be found to be appropriate where they provide a strong and sufficiently consistent correlation to the creation of value represented by the relevant (residual) profits.

4.6.5.17 **Example**

Company A designs and manufactures electronic components, which it transfers to a related Company B. Company B uses the components to manufacture an electronic product. Both Company A and Company B use unique and valuable innovative technological designs, which they have each developed themselves, to manufacture the components and electronic product, respectively.

Company C, a related Company, distributes the electronic products to unrelated customers. An arm's length transfer price for the transactions between Company B and Company C is determined based on the most appropriate method, the RPM. The PSM is found to be the most appropriate method to determine the arm's length transfer price between Company A and Company B because the contributions of both companies are found to constitute unique and valuable intangibles.

In step 1 of the residual analysis, a basic return for the respective manufacturing functions is determined for Company A and Company B. Specifically, a benchmarking analysis is performed to search for comparable independent manufacturers which do not own or use unique and valuable intangibles. The residual profit, which is the relevant profits of Company A and Company B in relation to the transactions after deducting the basic (arm's length) return for the manufacturing functions, is then split between Company A and Company B. It is found in this case that an economically valid way to split the residual profits would be based on relative R&D expenses, since these are found to provide a reliable measure of the relative value of each company's unique and valuable intangibles. Subsequently, the net profits of Company A and Company B are calculated in order to work back to a transfer price.

Example: Profit Splitting Factors

Company A is a designer, developer and manufacturer of construction and earthmoving equipment. Company B, an associated enterprise of Company A, has developed, by its own efforts a unique and valuable trademark and tradename to support the sale of the construction and earthmoving equipment. The brand developed by Company B hinges on the reliability of the equipment produced by Company A, as well as the extensive programme of customer support provided by Company B (including proactive maintenance, guaranteeing supplies of spare parts for equipment used in all, including remote, locations). A transfer pricing analysis determines that each party makes unique and valuable contributions and as a result, a residual profit split is found to be the most appropriate method. In determining how the relevant residual profits should be split, the key contributions of Companies A and B are considered. As a result of that analysis, reliable profit splitting factors based on those categories of R&D expenses (for Company A) relating to the unique and valuable intangibles embedded in the products; and marketing and customer support expenses (for Company B) are used.

4.7 The "Sixth Method" or "Commodity Rule"

4.7.1 Introduction

4.7.1.1 Transfer pricing rules require associated enterprises to price their intragroup transactions in accordance with the arm's length principle. The five methods described at sections 4.2 to 4.6 inclusive of this Practical Manual are used to calculate or test the arm's length nature of intragroup prices or profits earned from intragroup transactions. As described at 4.1.2.1, the starting point in selecting a transfer pricing method is an understanding of the controlled transaction (inbound or outbound) based on the comparability (including the functional) analysis. This is necessary regardless of which transfer pricing method is selected. The CUP Method is a suitable method when prices from comparable transactions of the same or similar products are available. For instance, the quoted prices on a commodities market or exchange may be comparable uncontrolled prices for transactions involving commodities performed by related parties under comparable circumstances.

4.7.1.2 Tax authorities may find themselves unable to successfully determine whether a controlled transaction between associated enterprises is comparable with uncontrolled transactions observed in the market if the taxpayer does not provide sufficient supporting documentation to its controlled transactions. For developing countries this concern may be even more pressing than for developed countries, as the former countries may not have data on companies doing business in their countries to perform a comparability analysis in addition to potentially having limited know-how and resources to conduct transfer pricing studies.

4.7.1.3 In view of this difficulty, several countries have a rule in place that is generally referred to as the so-called "sixth method" or "commodity rule" although the name of the rule or the method applied may differ from country to country. Historically this approach has been used for commodities by several countries. The common feature of these rules is that they rely on the quoted prices on the commodities market to price commodity transactions between associated enterprises. For practical purposes, in this section the approach will be referred to as the "sixth method".[41]

4.7.1.4 Because versions of the "sixth method" have been more widely adopted and applied in recent years, this section discusses the rationale for and country experiences with the "sixth method". However, this section does not seek to address the relationship between the sixth method as implemented in any particular domestic legislation and the arm's length principle as defined under Article 9 of UN Model Convention. The workings of the sixth method may resemble the Comparable Uncontrolled Price (CUP) Method. The sixth method generally considers certain characteristics and substance requirements, as defined in relevant domestic practices, for the method to be applicable to a particular transaction. Absent reliable and timely confirmation from the taxpayer about the relevant characteristics of the controlled transaction, some countries apply a default rule which includes the application of a transfer price based on publicly available pricing information and typically an assumption of the time the relevant tested transaction took place (which corresponds to the commodity price listing used). Despite its more general title, considering its operation, the sixth method—depending on how it is applied—could be considered as an anti-abuse rule, an abuse-deeming rule or even presumed to be a form of safe harbour. Some countries consider the sixth method an (imperfect) application of the CUP Method.[42] This section will refer to the

[41] As the rule is referenced as the "sixth method" in Argentina where it seems to have originated, for all practical purposes this title and wording will be used in this section.

[42] Brazil applies a similar sixth method approach to loan operations. For details, see chapter 15.

practice as “the sixth method” without addressing whether the term method, anti-abuse rule or abuse-deeming rule or safe harbour is more appropriate or legally more correct.

4.7.1.5 The sixth method approach has benefits and disadvantages. A benefit of the sixth method is its relative certainty and relative ease of application for the tax authorities and its tax collection efficiency. Some disadvantages of the sixth method include that it is not one of the traditional transaction methods or traditional transactional profit methods described in this chapter and thus may not be recognized by the country of the associated enterprise at the other end of the transaction. Disadvantages also include its inaccuracy considering the general standards of application of the arm’s length principle, that the method does not consider the economic circumstances of the actual transaction that is being tested, and that the method may result in overcompensation of one associated enterprise to the detriment of another associated enterprise and therefore may give rise to potential double taxation. Benefits and disadvantages are discussed further in section 4.7.5.

4.7.1.6 This chapter describes the so-called sixth method as it is observed in practice in several countries. It also discusses OECD guidance and an Inter-American Center of Tax Administrations (CIAT) study relevant to this method or approach that generally is used to tackle abusive transfer pricing practices. The chapter aims to provide a basic description of the application of the so-called sixth method in case of commodity transactions and a description of steps that can be taken to mitigate some identified disadvantages of using the sixth method.

4.7.2 Practical Operation of the Sixth Method

4.7.2.1 At the date of drafting this section, the sixth method has been adopted in countries such as Argentina, Bolivia, Brazil, Costa Rica, Dominican Republic, Guatemala, Honduras, Peru, Uruguay and some Caribbean countries. Practical experience with the rule exists mainly in Argentina, Brazil, Ecuador and Uruguay.[43] However, it should be noted that the method is not applied unequivocally in the same manner in all these countries. In Argentina, the method was first introduced in 2004. Other countries have followed in implementing (a version of) the sixth method since its first implementation in Argentina.

4.7.2.2 The fact pattern traditionally targeted by the sixth method is one where associated enterprises engaged in the business of exporting

[43] According to CIAT, the rule may be in place in several countries but practical experience with application of the rule is still quite limited.

commodities such as grains, oil and oilseeds, oil and gas, mining and fishing products, invoice an associated enterprise related to the sale of the commodities yet ship the commodities to a jurisdiction (and party) different from the associated enterprise that is being invoiced by the seller. The actual shipment date usually is at a later point in time than the date of the original sale between the associated enterprises and the inter-company invoice date. In general, the associated enterprise being invoiced is a trading entity that obtains title to the shipped goods only for a limited period of time and the later shipment is to a destination determined by an unrelated party that has bought the commodities from the associated trader (not to the residence of the associated trading entity).

4.7.2.3 If based on clear criteria that can be readily ascertained it is established that the associated trading entity has insufficient substance to perform relevant functions related to the acquisition and sale of commodities and the trading entity is located in a low tax jurisdiction, there is a risk that the associated trading entity transaction will erode the tax base of the jurisdiction of the seller of the commodities. This may result from paying a price for the commodities that is lower than that received by the associated trading entity from a third-party in a later sale, despite the fact that the trading entity does not have the substance to perform the trading functions. To curtail that risk, the sixth method determines the intragroup price by reference to the quoted price of the commodities on the shipment date, i.e. it looks through the intermediary trading entity as if the transaction had taken place between the seller and the third-party customer. The sixth method in some countries specifies that the intragroup sales price will be deemed to be the higher of either the exchange price of the commodity on the intragroup sale date or on the shipment date of the commodities to the unrelated buyer. Applied under these circumstances and in this way the sixth method can be considered to function as an anti-abuse rule.

4.7.2.4 As stated earlier, several countries that have implemented the sixth method have implemented it differently. CIAT describes the respective permutations of the sixth method observed in practice related to the different aspects that make up the rule as follows:[44]

[44] CIAT (2013). *The Control of Transfer Pricing Manipulation in Latin America and the Caribbean.* Panama City: CIAT. Available from https://www.taxcompact.net/sites/default/files/resources/2013-05-ITC-CIAT-Control-Transfer-Pricing-Manipulation-LAC.pdf

Table 4.T.10

Implementation of the Sixth Method

Aspect	Adopted approach
Transactions covered	▪ Only export transactions; ▪ Only import transactions; ▪ Import and export transactions.
Nature of the measure	▪ A way of applying the CUP Method. ▪ A way to arrive at an arm's length price; ▪ No specific determination.
Products or goods subject to the measure	▪ Renewable natural resources; ▪ and/or non-renewable natural resources; ▪ and/or goods with known quoted prices in transparent markets; ▪ not expressly established by regulation. ▪ Some regulations allow tax administrations to extend the measure to other goods provided that those meet certain requirements: ▫ the international intermediary does not have economic substance; ▫ and/or the tax agency considers it appropriate.
Relation condition	The condition by which the exporter and the intermediary trader and/or the actual intended recipient of the goods are related parties may be established in some countries, but not in all. At least one country (Brazil) applies the method whenever the foreign company is resident in a listed jurisdiction (non-cooperative, low tax jurisdiction, or under a privileged tax regime), regardless whether the companies involved are related enterprises.
Condition that there should be an international intermediary	The condition that there needs to be an international intermediary having no economic substance for the measure to be applied is expressly established in some countries, while it is not a requisite in others.
Hierarchy of the method	▪ Mandatory if the conditions established in the regulation are met; ▪ Optional, either this measure or the CUP Method may be applied; ▪ Not expressly established by the regulation.

Prices to be considered	▪ The higher price between the quoted price of the goods in the transparent market on the day they are loaded (for shipment) and the price agreed upon with the intended intermediary; ▪ Export and imports are afforded different treatment; ▪ For exports: research on international prices in accordance with the terms agreed upon by the parties as of the last shipment date unless there is evidence that it was agreed on another date; ▪ For imports: the price may not exceed the price based on international parameters as of the date on which they were originally purchased. ▫ Multiple criteria in a single regulation: (i) price on the transparent market on the loading or unloading date; (ii) average price over a 4-month period or 120 days prior to unloading or after loading; (iii) price as of the date on which the agreement was executed; (iv) average price over a 30-day term after the agreement was executed; (v) quoted price on the transparent market on the loading date, that of the prior date in which a quoted price was available or that of the first day the goods are loaded (the criterion adopted caries by country). ▫ Some countries accept the price agreed upon by the parties when the agreement is filed with the tax agency or with any other government agency a few days after it has been signed.
Comparability adjustments	Some countries allow for comparability adjustments to the publicly available price so as to take into account market circumstances, contract terms and conditions, and product quality and specifications whereas other countries do not accept comparability adjustments.

Exceptions to applying the measure	Some measures implemented in the region provide the local taxpayer with the possibility to evidence that the intermediary has economic substance, even though the criteria are not the same in every case.

4.7.2.4 Considering that the arm's length principle requires prices between associated enterprises to be comparable with those used between unrelated parties, it would generally be required that market prices be used that would apply in the same or similar circumstances as those that apply to the transaction between associated enterprises. Where the sixth method offers taxpayers the opportunity to provide evidence that the intragroup transactions are not abusive and the prices are at arm's length, and the method allows comparability adjustments as need be, it may be more generally consistent with the arm's length principle and provide for legal certainty. It can also help by providing the tax authorities with more transparency as regards the transaction between the associated enterprises.

4.7.3 OECD Guidance

4.7.3.1 The Group of Twenty (G20) and OECD countries have examined the transfer pricing aspects of cross-border commodity transactions between associated enterprises as part of Action 10 of the BEPS Action Plan. As a result, Chapter II of the OECD Transfer Pricing Guidelines has been amended to include new guidance especially applicable to commodity transactions.[45] The new guidance includes a clarification of the existing guidance on the application of the CUP Method to commodity transactions. The new guidance states that:

1) The CUP Method would generally be an appropriate transfer pricing method for commodity transactions between associated enterprises;

2) Quoted prices can be used under the CUP Method, subject to a number of considerations, as a reference to determine the arm's length price for the controlled commodity transaction; and

[45] OECD (2015). *OECD/G20 Base Erosion and Profit Shifting Project: Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10—2015, Final Reports.* Paris: OECD Publishing.

3) Reasonably accurate adjustments should be made, when needed, to ensure that the economically relevant characteristics of the controlled and uncontrolled transactions are sufficiently comparable.

4.7.3.2 The guidance also includes a provision on the determination of the pricing date for commodity transactions that, under certain conditions, provides for tax administrations to impute a pricing date. This provision acknowledges the difficulties that can arise for tax administrations in verifying the correct date for pricing the goods sold and serves to prevent taxpayers from using pricing dates in contracts that enable the adoption of the most advantageous quoted price. Although the price-setting date used by the parties is the prima facie date, in certain circumstances, for example if there is no evidence available as to what that date really is, the tax authorities can impute a pricing date, (*e.g.* the shipment date) in a manner similar to the sixth method.

4.7.3.3 Tax authorities in developing countries may find it easier to test the arm's length nature of intragroup commodity transactions if taxpayers are required to provide more information on such transactions. The OECD guidance referenced above emphasizes that taxpayers can assist tax administrations in conducting an informed examination of their transfer pricing practices related to commodity transactions by providing:[46]

- Documentation on the price-setting policy for commodity transactions;
- The information needed to justify price adjustments based on the comparable uncontrolled transactions or comparable uncontrolled arrangements represented by the quoted price; and
- Any other relevant information, such as pricing formulas used, third-party end-customer agreements, premiums or discounts applied, pricing date, supply chain information and information prepared for non-tax purposes.

4.7.3.4 The date of pricing commodity transactions is particularly relevant in determining whether such transactions between associated enterprises are priced appropriately. Tax administrations should determine the price for commodity transactions by reference to the pricing date agreed by associated enterprises, where the taxpayer can provide reliable evidence of the pricing date agreed by such associated enterprises in the controlled commodity

[46] OECD (2017). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.* Paris: OECD Publishing. Available from https://doi.org/10.1787/tpg-2017-en. See para. 2.21, section on commodity transactions.

transaction. Such evidence should include:

- The time the transaction was entered into (e.g. proposals and acceptances, contracts or registered contracts, or other documents setting out the terms of the arrangements may constitute reliable evidence), and
- That this is consistent with the actual conduct of the parties or with other facts of the case.

4.7.3.5 If the pricing date specified in any written agreement between the associated enterprises is inconsistent with the actual conduct of the parties or with other facts of the case, tax administrations may determine a different pricing date consistent with those other facts of the case and what independent enterprises would have agreed in comparable circumstances (taking into consideration industry practices). When the taxpayer does not provide reliable evidence of the pricing date agreed by associated enterprises in the controlled transaction and the tax administration cannot otherwise determine a different pricing date under the guidance on accurately delineating the transaction, tax administrations may deem the pricing date for the commodity transaction on the basis of evidence available to the tax administration. Such evidence may include the date of shipment as evidenced by the bill of lading or equivalent document depending on the means of transport. This would mean that the price for the commodities being transacted would be determined by reference to the average quoted price on the shipment date, subject to any appropriate comparability adjustments based on the information available to the tax administration. It would be important to permit resolution of cases of double taxation arising from application of the deemed pricing date through access to the mutual agreement procedure under the applicable treaty.[47]

4.7.4 CIAT Guidance

4.7.4.1 CIAT conducted a study to analyze the operation of the so-called sixth method 10 years after its introduction in Argentina.[48] In particular, it conducted a comparative analysis of the implementation of the sixth method in other Latin American countries. The study notes that transfer prices are calculated using the methods developed under the OECD Transfer Pricing Guidelines and that the methods are based on comparability of the transactions under analysis and that of other similar transactions carried out between or with independent parties. It also notes that a main problem

[47] Ibid. See para. 2.22, section on commodity transactions.

[48] Hereafter referenced as “the CIAT study”. Available from https://www.ciat.org/the-so-called-6th-method/?lang=en

encountered is the difficulty in assessing useful and timely information for carrying out such a comparison.

4.7.4.2 The CIAT study notes that authorities may react differently to distortions caused by companies being under common control. Some authorities may wish to disregard a legal entity making use of a substance-over-form analysis in case an enterprise is under the control of another enterprise in economic, financial and corporate terms. Other authorities may wish to make use of transfer pricing rules and determine the inter-company price that should apply by eliminating any pricing distortions that result from the influence of being associated enterprises. Although the traditional approach to the arm's length principle may be preferred, the CIAT study also notes that the complexity and practical difficulty in applying the transfer pricing methods and with finding comparables should allow for consideration of alternatives for developing countries, which may have limited resources to address the complexity that these exercises present or overcome practical difficulties in this respect.

4.7.4.3 When considering the legal nature of the sixth method, the CIAT study points out that the characterization of the method under domestic law may have consequences as regards the application of a treaty for the avoidance of double taxation. That is, to the extent the sixth method qualifies as a transfer pricing method, the workings of the Associated Enterprises article, usually Article 9 of a treaty for the avoidance of double taxation, may govern the international consequences of its application and to the extent it is seen as being a domestic anti-avoidance rule it may fall outside the scope of such a treaty and taxpayers may be unable to successfully claim avoidance of double taxation. If the method is characterized as an anti-abuse rule or a safe harbour, it will be relevant to get a treaty partner to acknowledge that, before a treaty can successfully be availed of to reduce any potential double tax.

4.7.4.4 In many cases, the sixth method may have been incorporated into domestic law to help prevent tax base erosion and facilitate the collection of corporate taxes. The method is most often applied to intragroup exports and/or imports of commodities and applies the publicly available market price of the commodity on the actual date of shipment as the transfer price. The method generally disregards whether the buyer or seller pays for the shipping costs and at what date delivery of the goods finally takes place. The method may also apply a cruder standard of comparability, in that the grade or quality of the commodity and sometimes even the volume shipped may not need to be the same as applies in a standard contract traded on the exchange. However, some countries and authorities allow for comparability adjustments to correct for this. The lack of substance of the intermediary is generally a given for the method to apply, although in practice there also are countries where the method is applied to all exports and imports regardless of (i) foreign intermediaries and/or (ii) the involvement of associated intermediaries.

4.7.4.5 The CIAT study goes further than the original sixth method in that it considers the position of the associated intermediary that makes the third-party sale. It recommends that tax authorities try to obtain an understanding of the value chain related to the commodity and its subsequent processing or transformation to help with determining the arm's length compensation for the functions performed, and risks assumed by the entities involved in that value chain.

4.7.5 Considerations for Use of the Sixth Method

4.7.5.1 Use of the sixth method offers some benefits but also carries with it some disadvantages as discussed above. The sixth method, in its most rudimentary form, operates as a price-setting mechanism that may roughly resemble the CUP Method. However, depending on how it is applied, it may not meet the rather strict requirements that the CUP Method traditionally requires for its application. Some countries consider it a benefit that the method can be used when no exact transfer price or comparable transaction is available for the commodities or products involved. This approach may serve as a practical means to raise revenue and requires relatively limited audit activity related to taxpayers engaged in intragroup commodity trading activities. A disadvantage of the approach is that, depending on how the sixth method is applied, there is a potential risk of divergence from the arm's length principle and resulting double taxation. Another disadvantage of the approach is that it does not apply a traditional transaction method or transactional profit method and hence may not be recognized by the country at the other end of the transaction. As a country's tax system and tax authorities develop and benefit from more transfer pricing–related know-how and resources, the sixth method may not or may no longer be necessary, or it may be adjusted or updated to achieve greater consistency with the arm's length principle.

4.7.5.2 It should be unequivocally clear in what situations the sixth method applies; this will avoid disadvantaging taxpayers and will foster legal certainty. If a (lack of) substance test applies, clear and objective criteria should be provided. Where a substance test is applicable, only when the taxpayer clearly fails to meet the test should the sixth method approach be applied. Potential double taxation resulting from application of the sixth method approach can also be a disadvantage. This disadvantage could be mitigated to the extent tax authorities would allow any double taxation resulting from the application of the sixth method to be eligible for potential relief under an applicable treaty.

4.7.5.3 Publicly available prices may be based on standardized agreements setting forth basic aspects of the transaction, such as quality, quantity and terms of delivery of the commodities marketed. A reliable application of the CUP Method would require that the raw materials being compared are sufficiently similar. Therefore, a closer application of the arm's length principle can be achieved to the extent that the sixth method allows for comparability adjustments to be made to the quoted prices for features such as physical characteristics and the quality of commodities as well as the volumes traded, the terms and conditions of the contracts, other relevant variables, the delivery date and conditions (CIF, FOB etc.) and whether the transaction between the associated enterprises is carried out at the same level of the supply chain as the one that served to set the publicly available price.

4.7.5.4 As stated earlier, the application of the sixth method in some countries is generally conditioned on the lack of (evidence on) substance of the intermediary trading entity. To the extent taxpayers may provide evidence as to the substance of (their associated) intermediary entities to opt out of the application of the sixth method, it could be expected that taxpayers will make an effort to provide the requisite additional information. As a result, the more accurate and arm's length income allocation may become that which applies between the associated enterprises.

4.7.5.5 Allowing for evidence or proof of substance is not uncommon with this approach. Doing so adds an administrative burden on taxpayers and tax authorities, however. As an example, one country's law and regulations provide in relevant part:

"the [sixth] method does not apply if and when: (a) the (associated) enterprise that constitutes the international intermediary, demonstrates effective presence in the jurisdiction of residence, having a commercial office or premises where the business is managed, complying with the legal inscription and filing of balance sheets; the assets, risks and functions undertaken by the international intermediary are adequate in view of its commercial operations; (b) the international intermediary's main business does not consist of receiving passive income or the trading of goods to or from the country of origin of the commodities or with other members of the economic group[49]; (c) the international intermediary's cross-border trade with other members of the same multinational group does not exceed 30% of the total annual transactions conducted by the intermediary."

[49] "Economic group" may be more extensive than an MNE.

4.7.5.6 Considering the observations resulting from the CIAT study mentioned in the previous paragraphs and the guidance issued by the OECD with respect to commodity transactions, to encourage access to treaty provisions providing potential relief from double taxation two observations can be made: First of all, in those situations where the rule considers the status of (foreign) intermediaries, it would be preferable if taxpayers are allowed to present evidence that their intermediaries have the requisite substance in the other jurisdiction(s). Second, taxpayers could be allowed to provide evidence that their intragroup pricing is at arm's length and appropriate and reasonable adjustments to publicly available commodity prices could be allowed in order to reflect possible transaction and product differences. This is important as commodity prices are known to fluctuate significantly and be highly dependent on grade, quality and specifics of the respective commodity. In addition, import/export conditions are likely to influence prices.

4.7.5.7 The less arbitrary the sixth method and its criteria for application can be, the more legal certainty may result and the more efficient and successful audits of transactions and taxpayers subject to the method can be. Clarifying the definition of intermediaries subject to the sixth method (if and when it refers to intermediaries), specifying the transactions subject to the sixth method and specifying the criteria for its application will assist in reducing uncertainty and potential tax disputes. To the extent taxpayers can provide evidence as regards to the necessary substance of intermediaries and what would constitute an arm's length price, and the legislation includes provisions for adjustments to the publicly available commodity prices to assure improved comparability, the sixth method becomes more sophisticated and in line with the arm's length principle. Taxpayers may benefit from (improved) access to avoidance of double taxation in that event as well.

5 Intragroup Services

5.1 Introduction

5.1.1 This chapter considers the transfer prices for intragroup services within an MNE. Firstly, it considers the tests for determining whether chargeable services have been provided by one or more members of an MNE to one or more associated enterprises for transfer pricing purposes. Secondly, if chargeable intragroup services have been provided, it considers the methods for determining an arm's length consideration for the services. The chapter also considers the circumstances in which tax authorities may provide taxpayers with the option of using a safe harbour for low value-adding services or for minor expenses.

5.1.2 Under the arm's length principle, if a chargeable intragroup service has been provided between associated enterprises, arm's length transfer prices should be charged to group members. The test for determining whether chargeable intragroup services have been provided between associated enterprises is whether one or more associated enterprises have received or are expected to receive an economic benefit from the activity. Such an economic benefit exists if an independent entity in the same or similar circumstances would be willing to pay for the services or perform the activity itself. This principle is referred to in this chapter as the "benefit test" and is considered in more detail below (section 5.2.2).

5.1.3 A transfer pricing analysis of intragroup services should be considered from both the perspective of the service-provider and of the associated enterprise receiving the services. The tax authority in the country of the service provider would seek to ensure that if chargeable intragroup services have been provided, the associated enterprise benefitting from the service is paying an arm's length price for such services. The tax authority of the service provider would be concerned if there were no payments for the intragroup cross-border services or if the charges for such services were below arm's length prices. It would also be concerned if the service provider incurred costs for the benefit of foreign associated enterprises without reimbursement or with less than arm's length consideration.

5.1.4 On the other hand, the tax authority in the country of the recipient would be seeking to ensure that the services in question satisfy the benefit test and that the recipient was being charged no more than arm's length prices for the intragroup services. A tax authority of the service recipient would consider making an adjustment if it considered that the services either did not in fact meet the benefit test to the local payer, or alternatively, if the services provided a benefit but the service charges were excessive. Given the scale of business operations of an MNE, service costs incurred and service charges may be significant and any misallocation of service costs or charges within an MNE will affect the profit or loss position of group members.

5.1.5 It should be noted that the requirement that chargeable services be paid for on an arm's length basis is distinct from the question whether such arm's length payments are deductible under the domestic law of the associated enterprise receiving the service. Transfer pricing rules require the payment of arm's length transfer prices for chargeable services. Principles of domestic law are then applied to determine if such payments may be deducted by the associated enterprise making the payment in determining its taxable income. In some countries, although an expense may satisfy the arm's length principle, the deduction may be denied, in full or in part, by domestic rules restricting deductions.

5.1.6 MNEs in a globalized economy may have highly integrated business operations. The associated enterprises comprising such groups may seek business advantages from exploiting information, technology and communications systems and other assets on a combined basis. Intragroup services may play an important role in MNEs as they seek to obtain needed services at the lowest price to maintain or improve their competitive position. Transfer pricing analyses of such service relationships should recognize that MNEs seek to maximize their profitability and competitive positions and they do not generally incur costs without a business purpose.

5.1.7 Many of the services that MNEs require may either be performed within the group or acquired by the group from one or more independent service providers. Many types of services are not within the company's core business but are nonetheless necessary for the MNE's business operations. The performance of service activities required by members of the group may be centralized in one group member or dispersed among many group members. In some cases MNEs may outsource services to independent enterprises and then charge out the cost of the services on a pass-through basis to those associated enterprises receiving the benefit(s).

5.1.8 Most intragroup services are easily identifiable. For example, where one member of the group performs hiring activities and manages payroll for another group member, it may be clear that a specific service has been provided. In some situations, a service may be connected with the provision of goods. For example, an associated enterprise might be provided with goods and it might also receive services to assist in the use of the goods. In other cases intragroup services may also be provided in conjunction with or embedded in intangibles or other assets.

5.2 Analysis of Intragroup Services

5.2.1 Types of Intragroup Services

5.2.1.1 Many types of intragroup services may be provided between the associated enterprises comprising an MNE. UNCTAD has noted in its *World Investment Report 2004: The Shift towards Services*, that it is "difficult to formulate a clear-cut definition of services. No commonly accepted definition exists."[50] A detailed list in Annex 1 at the end of this chapter (drawn up by the European Commission) sets out some of the types of intragroup services that are common in MNEs. The list is intended to be illustrative and is not comprehensive. Activities can generally be divided into chargeable services and non-chargeable activities. Chargeable services can be divided into low value-adding services and other services. Simplified transfer pricing approaches may be used for low value-adding services (see section 5.5.2) while a full transfer pricing analysis may be required for other services.

5.2.1.2 The profit margin which an associated enterprise may derive under the arm's length principle from providing intragroup services varies. A lower profit mark-up is appropriate for low value-adding services such as clerical or administrative services. Such services are necessary for the efficient operation of the international operations of an MNE but they do not create significant value. On the other hand, services associated with an MNE group's core business activities, which are incurred to maintain or improve the MNE's profitability, viability or market position, may create greater value and appropriately carry a higher profit margin.

5.2.2 The Benefit Test

5.2.2.1 The benefit test is used to determine whether a member of the MNE has received a chargeable service from an associated enterprise. The benefit test has two requirements both of which must be satisfied. Firstly, it must be anticipated that the activity will provide the service recipient with economic

[50] UNCTAD (2004). *World Investment Report: The Shift Towards Services*. New York UN Publishing: Available from http://unctad.org/en/docs/wir2004_en.pdf

or commercial value to enhance or maintain its business position. Secondly, it must be shown that an independent entity in the same or similar circumstances as the service recipient would have been prepared to pay for the services or perform the services itself. Once the benefit test has been satisfied, there remains the question of the arm's length price for the service (see section 5.3).

5.2.2.2 An examination of the facts and circumstances will be required to determine whether the benefit test has been satisfied for an enterprise receiving an intragroup service. The level of detail covered by such a factual examination, and the amount and nature of documentation required to demonstrate satisfaction of the benefit test, should be based on the materiality of the service charges.

5.2.2.3 The underlying notion of the benefit test is that, in order to be chargeable, the service must provide or be expected to provide the recipient with commercial value to enhance its actual or expected commercial position in an identifiable way. For example, a marketing programme may be designed by one member of an MNE to be used by associated enterprises operating as fully-fledged distributors with the expectation that all designated associated enterprises will benefit in each of their markets. Although the marketing strategy is a success in most countries, it may fail to deliver all of the expected benefits in some jurisdictions. As long as each associated enterprise within the MNE taking up this marketing strategy has legitimately expected a benefit, they have received a benefit for the purpose of the benefit test, despite the fact that some of these enterprises do not fully achieve the expected results. The benefit test is satisfied only if an independent distributor would be expected to pay for the marketing services under similar circumstances, or would need to perform the marketing services activities itself.

5.2.2.4 Whether or not the benefit test is satisfied does not depend on the level of risk that the expected benefit will or will not be achieved. Some intragroup services, such as research and development, may involve a higher level of risk than other services, such as accounting or bookkeeping services. Notwithstanding the risk involved, intragroup research and development services are chargeable if an independent party would have been expected to pay another independent party for the research and development services in the same or similar circumstances or it would have performed this activity itself. Provided the recipient associated enterprise expects a potential economic benefit from the research and development, the benefit test is satisfied and a chargeable service has been provided, even though the activity may not always actually result in benefits.

5.2.3 Service Activities for the Specific Needs of an Associated Enterprise

5.2.3.1 Associated enterprises may request the provision of specific intra-group services. Services provided specifically to one member of the MNE and designed specifically for its operations or requirements will generally satisfy the benefit test. For example, an associated enterprise which is part of an MNE involved in telecommunications may suffer reputational damage and a potential loss of business if information technology (IT) problems prevent customers from using its telecommunications system. If an IT problem arises and direct assistance is provided promptly to the associated enterprise by another member of the MNE specializing in the provision of IT services, the service would satisfy the benefit test as the associated enterprise has received an economic benefit to maintain its business operations.

5.2.3.2 Similarly, if an associated enterprise seeks assistance in the design of a targeted marketing campaign from a related party which specializes in marketing strategies and practices, the associated enterprise providing the marketing strategy advice is providing a service designed to meet the specific needs of the recipient. The benefit test would generally be satisfied in such a circumstance because the associated enterprise expects a commercial benefit from the service, and an independent enterprise in the same or similar circumstances would be willing to pay for the provision of such services or would undertake such activities itself.

5.2.4 Centralized Services

5.2.4.1 An MNE will often centralize certain business functions within an associated enterprise operating as a service provider to the rest of the group or to a subgroup of associated enterprises, such as a regional subgroup, for their benefit. A wide variety of services may be centralized in this manner, including both low and high value-adding services. Each associated enterprise benefitting from the services provided by a centralized service provider should be charged an arm's length price for the services it acquires, though the manner in which the arm's length charge is calculated may vary, depending on the facts of the case. The economic benefit is apparent if an associated enterprise would otherwise have to perform the activity itself or engage an external service provider.

5.2.4.2 There are numerous reasons for an MNE to provide intragroup services on a centralized basis. Services may be provided by an associated enterprise for the rest of the group in order to minimize costs through economies of scale. This may allow the MNE to increase its profits or improve its competitive position by being able to reduce the prices charged to customers. Centralizing services may allow for specialization within an MNE which may also involve the creation of centres of excellence. Some MNEs may centralize services in a regional management company for associated enterprises in a particular geographic region in order to align functional and management responsibilities. In some cases, an associated enterprise may not have the skills or resources locally in-house for the service it requires and may rely on specialists that are responsible for providing the same type of services across a wider geographic or functional grouping of entities. Another potential benefit of having centralized services for an MNE is the certainty that such services will be available when required and that the quality of the services is consistent within the MNE.

5.2.4.3 **Example 1: Airline Business**[51]

An MNE carries on an airline business in 5 countries (Countries A, B, C, D and E) with the parent of the group being located in Country A. Customers of the airline in these countries are provided with the option of calling staff by telephone to book travel and receive advice where necessary. The MNE decides to create a centralized call centre for the group to exploit economies of scale. The low cost of telecommunications and the ability to share business information among group members allows for the centralized call centre to be located in any country in which the MNE operates. The call centre can operate on a 24-hour basis in providing call services to all time zones in which the MNE carries on business. The MNE concludes that centralizing call centre functions in its subsidiary in Country E will allow the group to take advantage of both economies of scale and low costs. The call centre services provided by the subsidiary in Country E to the parent company and other group members satisfy the benefit test. Without the call centre the group members would either have to establish their own call centres or engage an independent party to provide call centre services on their behalf.

5.2.4.4 In the preceding example of a centralized call centre, a centralized facility operating on behalf of the businesses in each country replaces the individual local facilities for booking by phone in each country. A distinct and relatively small part of the businesses in each country is replaced with a centralized but still distinct part of the business. The change does not

[51] The examples contained in this chapter are some illustrations of the principle being considered.

affect the fundamentals of the businesses; for example, how the businesses contract with customers, or how the businesses generate demand through marketing strategies. In some situations, however, the centralizing of activities can affect the fundamentals of the businesses receiving the services, and those situations can be challenging to analyze for transfer pricing purposes. Depending on the facts, one such situation is that of centralizing sales or marketing activities. The section provides guidance on some of the factors that are likely to be relevant in analyzing centralized sales or marketing activities, so that the arrangements actually performed can be accurately delineated and evaluated in the context of the business of the MNE. Such an objective is common to all transfer pricing analyses, but offshore marketing companies are often an indicator suggesting further investigation in section 13.2.2.16 and the attribution of sales and marketing functions and risks to a centralized entity should be carefully analyzed, especially if the arrangements are not common between independent enterprises in the industry or the potential for profit shifting is significant because of the taxation regime to which the centralized entity is subject.

5.2.4.5 Commercial objectives for centralizing sales or marketing activities involve the general aims outlined in section 5.2.4.2 above, but more specifically can also involve cost savings (avoiding the duplication of costs in smaller markets by coordinating and aggregating activities), coordinating marketing activities and developing and exploiting marketing intangibles consistently, standardizing processes, prices and terms, responding to regional or global customers that may have similarly centralized their activities, and managing stock levels and warehousing more efficiently. In some cases, a centralized sales company may perform a range of activities: it may be responsible for fulfilling the orders solicited by the local in-market company; the centralized company may determine the sales and marketing strategy, develop and use its own marketing intangibles, assume inventory and pricing risk, and direct the activities of the local in-market company. In other cases, the centralized sales and marketing activity may provide a support function to the local in-market enterprises which remain responsible for performing a range of activities.

5.2.4.6 In analyzing arrangements involving the centralizing of sales and marketing activities, the first task is to understand those arrangements in the context of the business of the MNE and the nature of the transactions being undertaken. One important aspect may be to distinguish clearly between a centralized sales function and a centralized marketing function. Centralized sales functions may involve the order to cash processes, including centralized administration of invoicing and payments; and centralized sales functions may also involve the logistics of getting products to customers, including storage and transport. Centralized marketing functions may involve identifying the market opportunities, differentiating the offering in the market, and creating and maintaining consumer preferences. Either or both functions can be centralized, and a transfer pricing analysis requires clarity about the nature of the relevant functions, the extent to which centralization of functions has in practice taken place, the identification of risks and attribution of risks to the parties to the arrangements, and an evaluation of the contribution of the activity to how the MNE generates value.

5.2.4.7 Some businesses in which customers can find alternative products without repercussions may be characterized by a greater focus on marketing as a differentiator and contributor to performance. For example, the branded consumer goods sector may require extensive local in-market activities if the business requires very specific local market knowledge and bespoke marketing campaigns to compete with other sellers in the market; there may be differences in similar products around the world because of different consumer preferences in different markets; and there may be differences in sales channels because of consumer preferences or market maturity. In practice, the local in-market company may contribute local knowledge about the market and how to target sales and devise marketing campaigns, may propose sales channels, price points, inventory levels, and product ranges, and may be the only point of contact with customers. In such a case, the centralized sales function may provide support to the in-market companies through standardizing processes and saving costs on administrative and finance functions by centralizing those activities.

5.2.4.8 In other sectors, including the commodities sector (or sectors involving commoditized goods), the product may be identical or almost identical in all markets, the customers may be highly specialized and centralized, terms and conditions for contracts may be similarly specialized, inventory levels may be set globally, pricing and other terms may be negotiated or established centrally, and the sales and marketing strategies may be developed on a global basis, and may be limited if the business is characterized by longer term contracts with a relatively small number of customers. Storage and delivery may be a key aspect of the sales process (particularly for goods that require specialized facilities or processes such as ripening). In such a case, the contribution made locally is likely to be different to the branded consumer goods example and may be limited to developing or managing a relationship with a small number of customers, whereas the selling activity is conducted by the centralized company.

5.2.4.9 A typical evidentiary issue relating to centralized sales and marketing activities concerns the relative decision-making responsibilities of the local in-market company, other associated enterprises such as the producing company, and the company providing centralized services. One aspect may involve which party, the local in-market company, other associated enterprises such as the producing company, or the company providing centralized services, controls significant risks associated with the sales activities through the performance of relevant decision-making (see section 3.4.4.33 to 3.4.4.35). Another aspect may involve determining which party performs important functions associated with the development/acquisition, enhancement, maintenance, protection, and exploitation of marketing intangibles (see section 6.3.4). In situations where the non-resident centralized sales company is responsible for concluding sales in the local market, then it may be appropriate to consider whether those activities create a deemed permanent establishment under Article 5 of the UN Model Double Taxation Convention.

5.2.4.10 The principles found in the guidance on centralized procurement activities, which can be found at the end of this Chapter (section 5.6 et seq.) may also be instructive when analyzing centralized sales and marketing activities. In particular, this guidance may assist in analyzing situations where the local in-market company sells to an intermediary group company.

5.2.5 On-call Services

5.2.5.1 Intragroup on-call services apply in a situation where an associated enterprise agrees to provide a particular type of service immediately or within a short period of time. In order to do so it must maintain the staff necessary to provide such services promptly as requested, even though some staff members may not be fully utilized by the MNE at all times. On-call services may also be called "call-off contracts" and "stand-by contracts". The expected economic benefit to the recipient of being able to call on such services without delay when needed may be a sufficient business advantage to satisfy the benefit test, even if the contingency requiring the service never arises and actual services are never or infrequently provided. An associated enterprise that is a potential recipient of such on-call services would therefore be expected to pay the service provider for maintaining the necessary staff to provide the service, even during times when the potential recipient does not call on the associated enterprise to provide the service. The existence of an economic benefit for on-call services will need to be considered on a case-by-case basis to ensure that an associated enterprise is actually receiving a benefit from having a service provider on-call and that an independent enterprise in the same or similar circumstances would have been willing to pay.

5.2.6 Non-chargeable Activities

5.2.6.1 Certain intragroup service activities do not meet the benefit test for one or more associated enterprises, and so would not warrant charges. It is emphasized that a determination of whether an intragroup service has been provided to a particular associated enterprise depends on an analysis of the facts and circumstances of each case. The following section deals with four situations in which the benefit test is not met.

Shareholder Activities

5.2.6.2 Shareholder activities are activities undertaken to provide an economic benefit only to the shareholder company (ultimate parent company or any other shareholder such as an intermediary holding company, depending on the facts of the case) in its capacity as shareholder. Accordingly, the cost of shareholder activities should be borne exclusively by the shareholder. Shareholder activities performed by an associated enterprise on behalf of its parent company should be charged to the parent company on an arm's length basis.

5.2.6.3 Shareholder activities may include the following:

- The preparation and filing of reports required to meet the juridical structure of the parent company;
- The appointment and remuneration of parent company directors;
- The meetings of the parent company's board of directors and of the parent company's shareholders;
- The parent company's preparation and filing of consolidated financial reports, reports for regulatory purposes and tax returns;
- The activities of the parent company for raising funds used to acquire share capital in subsidiary companies; and
- The activities of the parent company to protect its capital investment in subsidiary companies.

5.2.6.4 Company law usually requires that a company should be managed by a board of directors. A company's board of directors is required to make the key business, investment and policy decisions of the company. The role of company directors is usually to act in good faith in the best interests of the company. A jurisdiction's company law will usually prescribe the legal duties of a board of directors. The cost of a parent company's board of directors may constitute shareholder expenses and in that case the cost cannot be attributed to associated enterprises. In this situation, the only enterprise in an MNE that would satisfy the benefit test is the parent company. The non-chargeable directors' costs would include the directors' fees and the cost of holding meetings. If a parent company in an MNE is supervising its investments in the group through a supervisory board, the cost of the supervisory board may be a shareholder expense that cannot be attributed to an associated enterprise.

5.2.6.5 Directors of a company may also engage in other activities in connection with the parent's ownership interests and these expenses would also be treated as shareholder expenses. However, directors may also provide services that result in the provision of material and recognizable benefits to members of an MNE other than the parent company. In this situation, the determining factor is whether a service has been provided to associated enterprises. If it is determined that a service has been provided, the next issue to consider is which group members satisfy the benefits test for the service.

5.2.6.6 Another example of a shareholder expense is the cost of obtaining financing by the parent of an MNE to acquire a company; as such costs fail to provide an immediate benefit to the acquired entity. If a parent company raises funds from an independent lender on behalf of an associated enterprise that is a regional headquarter company to acquire a new company, this activity can be a chargeable financial service to the regional headquarter company. It would satisfy the benefit test if an independent party would have been willing to pay for the financial services in comparable circumstances. In this situation a service charge from the parent company to the associated enterprise on behalf of which the funds are raised would be appropriate, as the parent company has provided services in the form of being the associated enterprise's agent to raise finance.

5.2.6.7 **Example 2: Listed Company**

Controller Co. is a resident of Country A and it is the parent company of an MNE. Controller Co. is listed on the stock exchange in Country A, and it is required by the stock exchange and securities regulators to report its financial position periodically. The reporting requirements include the MNE's consolidated profit and loss statements and balance sheet prepared in accordance with International Financial Reporting Standards. Subsidiary Co. is a subsidiary company resident in Country B and maintains its own accounting function to support the operation of its business. Subsidiary Co. is required under the domestic law of Country B to prepare its accounts in accordance with International Financial Reporting Standards and to annually file statutory financial statements. Subsidiary Co.'s chief financial officer provides certain reports and financial statements to Controller Co. for inclusion in the MNE's consolidated financial statements. The incorporation of this material into Controller Co.'s consolidated financial statements is an action that Controller Co. carries out as a shareholder of Subsidiary Co. Therefore Controller Co. cannot impose a service charge on Subsidiary Co. for reviewing and incorporating its financial statements into the MNE's consolidated financial statements that Controller Co. is required to file, as these activities do not provide Subsidiary Co. with a benefit. These activities are exclusively attributed to the obligations imposed on Controller Co. as a listed company. If Subsidiary Co. incurs costs in preparing financial statements required for the MNE's consolidated financial statements that exceed what is necessary to meet the financial reporting requirements in Country B, Controller Co. should compensate Subsidiary Co. on an arm's length basis for the additional activities.

Duplication of Activities

5.2.6.8 Duplication of services occurs when a service is provided to an associated enterprise which has already incurred costs for the same activity performed either by itself or on its behalf by an independent entity. Duplicated activities are usually not chargeable services. The determination of duplication must be made on a case-by-case basis. There are some circumstances in which duplication may provide an associated enterprise with a benefit if an independent party would have been willing to pay for the duplicated services in similar circumstances. For example, this situation may arise if an associated enterprise receives in-house accounting advice on an issue but chooses to get a second opinion to minimize the risk of being penalized for failing to comply with accounting standards.

5.2.6.9 At times an MNE may engage in service functions which have the same name but represent different services, or, the functions are performed at different levels and therefore do not involve duplication. These functions may be carried out at the group, regional or local level. For example, strategic marketing functions are performed at the group level as they are for the benefit of the entire group, while at the local level a subsidiary engages in marketing analysis of the local market conditions. In this situation the marketing services are not duplicated as they are different types of services.

5.2.6.10 **Example 3: Use of Group IT Services**

Company X, resident in Country X, is part of an MNE. Company X uses the group's integrated IT system which is supported by IT services provided by a group service provider, Company T. Assume that these services meet the benefit test for Company X. It is determined that an arm's length charge for Company X for these services is 60. As a result, Company X's accounts include a charge for "IT services" paid to Company T of 60. Company X also sources IT services from a third-party supplier in Country X in order to customize its IT system to local requirements. As a result, Company X's accounts include a further charge, also described as "IT services", of 40.

In this example, despite being described the same way in Company X's accounts, the two charges refer to different services and both would be allowable since the intragroup charge refers to services which meet the benefit test and are at an arm's length price, and the other services are also at arm's length.

If the IT services relating to the localization of Company X's systems were instead sourced from an associated enterprise, assuming both kinds of services meet the benefit test and constitute an arm's length amount, the same outcome would apply.

5.2.6.11 When an activity is in the process of being centralized for an MNE, acceptable duplication may occur during the transition phase. For example, an MNE may decide to centralize its human resources function for the group and this alteration would require the closure of each associated enterprise's human resources department after the necessary data has been provided to the centralized human resources database. This process is likely to involve a period of overlap and acceptable duplication during the transition phase. In this situation an independent entity would have a period of duplication if it were in the process of outsourcing its human resources function to an independent service provider. Nevertheless, care should be taken in determining whether a situation involves acceptable duplication.

5.2.6.12 **Example 4: Agribusiness Subsidiary of MNE**

Subsidiary Co., a company resident in Country A, is part of an MNE. The group's business is growing primary produce and distributing it in local markets. The parent company is Parent Co. in Country B. Parent Co. oversees treasury functions for the group. Parent Co.'s treasury function ensures that there is adequate finance for the group and monitors the debt and equity levels on its books and those of its subsidiaries. Subsidiary Co. maintains its own treasury function and manages its finances on an independent basis. It manages its treasury operations and ensures that it has finance available either in-house or externally. A functional analysis indicates that Subsidiary Co. carries on its own treasury functions in order to ensure that it has adequate debt capital to finance its operations. In this situation duplication arises as Subsidiary Co. is performing treasury functions necessary for its operations and Parent Co. is performing the same treasury functions for Subsidiary Co. Accordingly, Parent Co.'s treasury activities are duplicated activities that fail the benefit test. Under the arm's length principle, Parent Co. cannot charge a service fee to Subsidiary Co. for Parent Co.'s treasury functions.

5.2.6.13 **Example 5: Treasury Services**

An MNE has its Parent Company in Country A. Parent Company performs treasury functions for itself and its subsidiaries. The treasury functions include raising capital, obtaining financing and cash management. Subsidiary Company is an associated enterprise in Country B and does not perform any treasury functions itself. In this situation there is no duplication as Subsidiary Company does not perform treasury functions. In this case, Subsidiary Company is considered to obtain a benefit from the functions performed by Parent Company.

5.2.6.14 **Example 6: Services Related to IP Rights**

An MNE has a parent company called Controller Company in Country A. Controller Company has in-house legal advisers with expertise in intellectual property. The expertise includes registering patents and protecting intellectual property rights. Property Company is an associated enterprise in Country B and it is the legal and economic owner of patents that it has developed itself for its own benefit. Property Company has a dispute with one of its customers over the improper use of its intellectual property. Property Company attempts to discuss the dispute with the customer but the customer denies that there is a breach of the licence agreement and refuses to negotiate. Property Company does not have in-house legal counsel and engages an independent legal firm in Country B to provide it with advice on whether it is entitled to damages from the customer for the purported breach of the agreement.

The legal advice is that the customer is in breach of the license agreement and that Property Company should take legal action to recover substantial damages from the customer. As litigation is expensive, Property Company seeks a second opinion from Parent Company on whether it should take legal action against the customer. Country A and Country B have similar legal systems in respect of intellectual property. Parent Company uses its in-house legal counsel to provide advice on whether Property Company is entitled to damages for the breach of agreement as well as assessing the extent of the damages. In this situation the legal advice provided by Parent Company has provided Property Company with an economic benefit as it provides the comfort of a second opinion. In this situation there is no duplication and the use of a second legal opinion is a justified measure for dealing with the dispute with the customer. Independent entities involved in legal disputes regularly seek a second opinion to assess a legal dispute.

Passive Association

5.2.6.15 Benefits to members of an MNE may arise solely as a result of an associated entity's membership in the MNE. Such benefits are attributable to the entity's passive association with the MNE. The benefits of association with an MNE are not a chargeable service for members of the MNE. For example, independent enterprises transacting with an enterprise that is a member of an MNE may be willing to provide goods or services to it at prices that are below the prices charged to independent buyers. These discounts may be provided because the independent supplier hopes that it will be able to generate future sales to other group members if it provides favourable pricing and good service. Moreover, the associated enterprise may be viewed by the independent supplier as a low risk customer that is unlikely to default on any trade credit. It is emphasized that in this situation the independent enterprise has made an assumption on credit risk as it cannot take legal action against the parent company if the subsidiary defaults, because the parent has not provided the enterprise with any formal guarantee or undertaking to cover the amount owing by the subsidiary.

5.2.6.16 Under these circumstances, the associated enterprise's membership in the MNE does not result in a chargeable service being provided to the associated enterprise by the parent company or any member of the MNE. The key feature of this type of incidental benefit is that it is passive and cannot be attributed to an overt action taken by another member of the MNE. In contrast, if a member of an MNE provided an explicit, formal guarantee of an associated enterprise's trade credit, the formal guarantee may be a chargeable service provided that an independent entity would have been willing to pay for a formal guarantee in similar circumstances. (Guidance on intragroup financial guarantees can be found at Chapter 9). Another example of a situation in which a chargeable service may occur is where an associated enterprise is able to get additional discounts from an independent supplier on condition that other MNE members commit to additional purchases from that supplier.

5.2.6.17 The passive association of an associated enterprise with its MNE may improve the associated enterprise's credit rating. There are circumstances where an associated enterprise that is part of an MNE may enjoy a higher credit rating from lenders on the basis of its membership in the MNE. That is, if the associated enterprise were assessed on a purely stand-alone basis (i.e. as if it had no associated enterprises), it would be expected to receive a lower credit rating from the lender. In this case, the associated enterprise has received an incidental benefit from its passive membership of the MNE. In this situation there is no chargeable service. This incidental benefit cannot be subject to a service charge from other group members. On the other hand, if the parent company provided a lender with a formal guarantee for a loan made to an associated enterprise, the parent may be actively seeking the advantage of a lower finance charge for the associated enterprise and the guarantee may, accordingly, qualify as a chargeable service for transfer pricing purposes requiring the payment of an arm's length guarantee fee. See 2.5.5 for further discussion of the relationship between group synergies and passive association benefits and Chapter 9 for guidance on intragroup financial guarantees.

Incidental Benefits

5.2.6.18 There are other situations in which one associated enterprise may provide an intragroup service to another associated enterprise under circumstances where that service also incidentally gives rise to benefits being received by other members of the MNE other than the primary beneficiary of the service. Whether follow-on benefits to other group members may support the payment of service fees by the incidental beneficiaries depends on the facts. The determination of whether a service fee should be paid by the incidental beneficiaries of the service depends on whether an independent party in the same circumstances would have been willing to pay for the intragroup service. In some cases, the incidental follow-on benefits that an associated enterprise receives may be remote and would fail the benefit test as an independent party would not be willing to pay for the service.

5.2.6.19 Example 7: Marketing and Distribution Services

Motorcycle manufacturing MNE X has an associated enterprise that serves as a distribution company in Country A, which is incurring losses. The parent company's marketing department is asked for assistance and advice as to how to make the associated enterprise in Country A profitable. After studying Country A's consumer market and comparing that market with other markets where MNE X motorcycles are sold, the parent company's marketing department develops a marketing campaign for Country A where specifically adorned and highly decorated motorcycle helmets are given away for free together with motorcycles sold in Country A. There is no law requiring the use of motorcycle helmets in Country A.

The marketing campaign is a success and sales in Country A increase over the next year. The helmets are actually quite popular due to their specific designs and adornments. In the following year, an independent study shows that motorcycles of MNE X are less likely to be involved in deadly accidents. This study boosts the sales of MNE X's motorcycles in Country A. The associated enterprise in Country A is allocated the cost of the marketing campaign by the parent company.

As a result of the independent study on motorcycle safety, however, the sales of MNE X motorcycles go up in Countries B, C and D as well. These countries also have no laws that require the use of motorcycle helmets when riding a motorcycle. The issue is whether the marketing campaign cost incurred by the parent company's marketing department perhaps ought to be allocated to associated enterprises in Countries B, C and D as well. The increased sales in Countries B, C, and D appear to be incidental benefits of the marketing campaign developed for Country A specifically and allocation of costs to the associated enterprises in Countries B, C and D would therefore not be in line with the arm's length principle.

5.2.6.20 Example 8: Corporate Services

Assume that an MNE has an Asia Pacific regional headquarters company that requests the management of its parent company to review the structure and operations of associated enterprises in that region to ensure the regional group maintains its profitability. The managerial review of the associated enterprises may result in the decision to terminate certain business activities which are failing to meet profit expectations and are unlikely to improve. The reduction in profitability may be the result of structural market changes caused by technological developments. In this situation, the review would satisfy the benefit test at the level of the regional holding company. An independent enterprise in the same circumstances would be willing to receive advice from an independent management enterprise. The resulting decision on which business lines to retain and discard may provide incidental benefits for associated enterprises which are regional headquarters in other regions, such as South America. If the business lines of the associated enterprises in other regions are similar to the Asia Pacific region, then the benefit test has been satisfied and a service charge may be imposed on these associated enterprises. On the other hand, if the business lines in the other regions are dissimilar, these associated enterprises cannot be subject to a service charge for the follow-on benefits resulting from the managerial review. In this circumstance, the benefit test would fail to be satisfied if an independent party would be unwilling to pay for an evaluation of business lines not relevant to its business.

5.2.6.21 There are some cases where a service performed by an MNE member benefits or is expected to benefit only certain MNE members, but incidentally provides benefits to other members. Examples could be analyzing the question of whether to reorganize the group, to acquire new members or to terminate a division. These activities could constitute intragroup services to the particular MNE members involved; for example, those members who will make the acquisition or terminate one of their divisions, but they also may produce economic benefit for other MNE members not involved in the decision by increasing efficiencies, economies of scale or other synergies. The incidental benefits ordinarily would not cause these other MNE members to be treated as receiving an intragroup service because the activities producing the benefits would not be ones for which an independent enterprise ordinarily would be willing to pay.

5.3 Determining an Arm's Length Charge

5.3.1 Functional Analysis

5.3.1.1 If chargeable intragroup services have been rendered, the next step is to determine the arm's length service charges for transfer pricing purposes. Under the arm's length principle, charges for the services should reflect the charges that would be paid or received by independent entities in the same or similar circumstances. The arm's length price for services should be considered from both the perspective of the service provider and the perspective of the service recipient. In this respect, relevant considerations include the value of the service to the recipient and how much a comparable independent enterprise would be prepared to pay for that service in comparable circumstances (given the extent of the benefit it expects to receive from the service), as well as the costs of providing the service incurred by the service provider.

5.3.1.2 As can be seen from a review of the types of services listed in the overview in Annex 1 at the end of this chapter, services that may be provided between associated enterprises vary widely both in nature and value. Some services may be routine or administrative in nature and can appropriately be compensated at prices approximating the cost of the service plus a small mark-up. Other services may be unique, require significant skill to perform, involve the use of valuable intangibles of the service provider, and may be key contributors to the profitability of the MNE. At arm's length, such services may command prices that result in significant profits for the provider of the service. Accordingly, no single approach to determining arm's length prices will be appropriate in all situations. Specifically, the CPM will not always yield the best estimate of the arm's length value of the services provided.

5.3.1.3 To determine an arm's length charge for intragroup services, a functional analysis should be undertaken. The functional analysis would consider the functions performed, the assets used or contributed and the risks assumed by the service provider. The functional analysis would also consider any involvement of the service recipient and the use the service recipient makes of the service in conducting its own business. The functional analysis would provide evidence of the economic benefit expected or received from the services by the recipient and it would also provide assistance in determining the reliability of available comparables. If a service activity is a separate activity engaged in for the benefit of the group, the functional analysis of the service provider may be relatively simple. If the services are connected with the provision of know-how or other intangibles, the analysis may be more complex. Intangibles are considered in Chapter 6.

5.3.1.4 An example of a chargeable service activity would be the provision of marketing services for an MNE by an associated enterprise. The functional analysis of that activity may involve an analysis of the activities of the associated enterprise's staff in designing and implementing the marketing services. This consideration would also involve the skill and expertise of the staff of the service provider and the time involved in developing the marketing strategy. The assets used or contributed may include the business premises as well as an office and computer equipment. The intangibles involved may include knowledge of independent enterprises providing advertising services, customer lists and know-how developed through other marketing campaigns.

A marketing strategy may involve an element of risk as a prediction can only be made on the expected outcomes of the campaign.

5.3.2 Charging Approaches

5.3.2.1 There are two general approaches that may be used in charging for services, the direct charge and the indirect charge.

5.3.2.2 The direct charging approach requires that, for specific services provided, the beneficiary of the services and the price for those services must be identified. In general, any of the transfer pricing methods identified in the following section may be applied to identify an arm's length price under a direct charging approach. For example, a foreign subsidiary may be directly charged for a two-day visit of a software engineer who is employed by the parent company and who may have visited the foreign subsidiary's site at the latter's request to render certain consultancy or advisory services. In such a case the parent company can charge the specific costs for these consulting services with or without a profit mark-up (as may be appropriate) directly to the foreign subsidiary.

5.3.2.3 A direct charging approach may be difficult to apply and the administrative cost of direct charging may be an administrative burden which is disproportionate to the services provided, particularly where services may be provided to more than one recipient within the group. Many MNEs have developed indirect charging approaches based on apportionment to reflect the relative benefit that each associated enterprise is expected to receive from the provision of intragroup services. A sound indirect charge approach would use allocation keys based on objective factors which are proxy measures for the relative economic benefit each associated enterprise receives from centralized services. The allocation keys are considered in section 5.4.8. Allocation keys are acceptable provided they reasonably comply with the arm's length principle. The main feature of indirect approaches is that the allocations are estimates of the relative benefits that associated enterprises expect to receive from services. The allocation may be based on a single factor or several factors used in combination. For example, if human resources services are centralized for an MNE, the allocation may be based on the number of employees in each associated enterprise. For services related to marketing, an appropriate allocation key may be turnover.

5.3.2.4 In some cases, it may be difficult to measure the expected economic benefit of some centralized services within an MNE. For example, it would be difficult to estimate the benefit of a promotional campaign at a major national sporting event which has a worldwide television audience. Once the promotion rights are obtained and a payment made, the MNE is required to allocate the cost of the centralized promotion prospectively on the basis of the expected economic benefit for MNE members. Tax administrations of developing countries often find it difficult to verify the validity of these types of fees. Furthermore, determining whether the applied allocation is in accordance with the arm's length principle is another practical difficulty since intragroup services are mostly charged by applying an indirect charge approach, utilizing various allocation keys. When the parent company of an MNE is located overseas, the local subsidiary companies can often only provide information regarding their own operations instead of an overall understanding of the entire intragroup services structure. Potentially relevant information could be whether associated enterprises in other countries that similarly benefit from the services follow the same methodology to pay the service fees and the actual amount of the service fees charged to the various associated enterprises.

5.3.2.5 Generally, the direct charge approach is preferred over the indirect charge approach in cases where the services rendered by an associated enterprise to other MNE members can be specifically identified and quantified. In many circumstances, MNEs will not have an option but to use indirect cost allocation. In such cases, intragroup services charged on an allocation basis will be acceptable if the allocation is a reasonable reflection of the expected benefits (see section 5.4.8).

5.3.3 Provision of Assets and Ancillary Services

5.3.3.1 It may be necessary to distinguish between the transfer of tangible or intangible assets and the provision of ancillary services. For example, services may include the provision of training or advice on the use and operation of machinery and equipment. In the case of intangible assets, the services may be training and assistance on the use of technology protected by patents, copyright or know-how. If the provision of intragroup services is separate from the provision of tangible or intangible assets then a separate arm's length service charge may be appropriate. Determining whether a service is connected to the transfer of tangible or intangible assets depends on the facts and circumstances of the transaction.

5.3.3.2 If a payment for tangible or intangible assets already includes the price for accompanying ancillary services, a separate service fee may be inappropriate as this would involve a second charge for the same services. The transfer price for such transactions may be supported by comparables in which similar ancillary services are provided, such as internal comparables. It may be difficult to obtain external comparables. On the other hand, if the transfer price for the transfer of a tangible or intangible asset did not cover the provision of services, it would be appropriate for a separate service charge to be made.

5.3.3.3 **Example 9: Crimson Co.**

Crimson Co. is a resident of Country A and the parent of an MNE that carries on a business of mining and processing minerals. Violet Co. is an associated enterprise resident in Country B and also carries on a business of mining and processing minerals. Crimson Co. has developed a processing system for minerals which reduces the cost of processing and the processing time. The processing system is know-how and Crimson Co. has not sought a patent for it. Crimson Co. agrees to provide a licence to Violet Co. for the right to use its know-how for the processing of minerals. The royalty fee for the licence to use the know-how is three per cent of Violet Co.'s income from sales of minerals to independent customers. Under this arrangement, Crimson Co. agrees to provide ancillary services to the staff of Violet Co. on the use of the know-how. A functional analysis has been carried out by Crimson Co. and appropriate comparables have been identified in setting the three per cent royalty fee, and in confirming the fee is arm's length. In addition to providing a licence to use similar intangibles, the comparables provide the same or similar ancillary services, the fees for which are embedded in the royalty fee. In this situation, Crimson Co. has been fully remunerated for the provision of know-how and any ancillary services by the three per cent royalty fee. It would be inappropriate for the tax authority in Country A to claim that the royalty payment only applies to the licence of the intangibles and that Crimson Co. should receive a further payment for the provision of ancillary services. The fees for the ancillary services are embedded in the transfer price relating to the licence for use of the know-how. Consequently, it would be inappropriate for any additional service charges for the ancillary services to be imposed on the associated enterprise.

5.4 Calculating Arm's Length Consideration

5.4.1 Introduction

5.4.1.1 For both direct and indirect charging approaches, the transfer pricing methods in this Manual at Chapter 4 may be used to determine arm's length prices for intragroup services provided that they are reliable. If there is a disagreement between the tax authorities of the service provider and the service recipient on intragroup service charges, double taxation may occur. See Chapter 4 for a detailed discussion of the transfer pricing methods that can be appropriate for intragroup services, i.e. the Comparable Uncontrolled Price (CUP) Method, the Cost Plus Method (CPM), the Transactional Net Margin Method (TNMM) and, in some circumstances, the Profit Split Method (PSM).

5.4.2 Comparable Uncontrolled Price (CUP) Method

5.4.2.1 The CUP Method (see 4.2.1) requires a high degree of comparability between controlled and uncontrolled transactions. If an MNE's service provider renders the same services in comparable circumstances to independent entities as it provides to associated enterprises, these may qualify as internal comparables allowing it to apply the CUP Method. In addition, the service provider would have a charging system in place. Similarly, if an associated entity receives the same or similar services from both an associated enterprise and from independent service providers, that entity may be able to use these as internal comparables for the CUP Method. If the service provider only provides centralized services to intragroup members, external CUPs may in some cases be available. A potential CUP may be used provided it is comparable to the intragroup services. However, for the CUP Method to be applicable, an analysis of the types of services provided in controlled and uncontrolled transactions is required.

5.4.2.2 The CUP Method may not be applicable if services are only provided within an MNE and there are no comparable uncontrolled transactions between independent parties. In performing the comparability analysis, the controlled and uncontrolled transactions should be compared based on the comparability factors discussed in Chapter 3. As the CUP Method requires a high degree of comparability, details on the services rendered, functions performed, assets used or contributed and the risks assumed in controlled and uncontrolled transactions may be needed. In addition, comparability may be affected if provision of the services involves the use of intangibles. Other comparability factors may have an effect on the prices charged in uncontrolled transactions such as quantity discounts and contractual terms, including those which may provide extended periods for payment of services rendered and associated guarantees.

5.4.2.3 If there are material differences between controlled and uncontrolled service transactions, reasonably accurate comparability adjustments are required. If such comparability adjustments cannot be made, the reliability of the CUP Method will be reduced and the CUP Method may not be the most appropriate method. While comparable service transactions between independent parties may take place, it is unlikely that the critical information on these transactions (such as the prices charged, functions performed, assets used or contributed and risks assumed by the parties) will be available for comparison. This type of information on uncontrolled transactions is often confidential and unlikely to be publicly available.

5.4.2.4 Example 10: Logistics and Shipping Services

Grain Co. and Shipper Co. are associated enterprises. Grain Co. is resident in Country A and produces wheat for export. Shipper Co. is resident in Country B and carries on a business of providing grain shipping services. Shipper Co. provides grain shipping services to four independent enterprises and approximately 60 per cent of its business is made up of performing shipping services to these independent customers. 40 per cent of its business consists of performing similar shipping services for Grain Co. In this situation it is likely that Shipper Co. would be able to use the CUP Method as it has internal comparables to use in setting its transfer prices for Grain Co. The reliability of the comparables depends on a comparability analysis. Assume that there is a high level of comparability in terms of the type of service provided, the volume of transactions, the contractual terms and the economic conditions. In this case, Shipper Co. would be able to use the internal comparables in setting its transfer prices for shipping services provided to Grain Co.

5.4.2.5 Example 11: Shipping Services Provider That Also Provides Services to Third Parties

The facts are the same as Example 10, except that 90 per cent of Shipper Co.'s business is providing shipping services to Grain Co. The remaining 10 per cent of its business is providing shipping services on an ad hoc basis to independent customers. Assume further that the independent customers only use Shipper Co. in times of acute shortage of shipping capacity by other independent shipping enterprises. In these cases, shipping services may be more costly than when there is no shortage. In this situation, the comparability analysis is likely to lead to the conclusion that the comparables need to be adjusted for the significant differences between the controlled and uncontrolled transactions which would affect the shipping charges, or that the transactions are in fact not comparable.

The main differences on the facts are the volume of business (90 per cent of volume originated by Grain Co. and 10 per cent by independent entities), the market situation and the regularity of providing grain transporting services that must be taken into account as they would be expected to have a material effect on the transportation charges. If reasonably accurate adjustments for material differences between the controlled and uncontrolled transactions cannot be made, the reliability of the CUP Method will be reduced and the CUP Method may not be the most appropriate method.

5.4.3 Cost Plus Method (CPM)

5.4.3.1 In practice, it is often the case that the CUP Method is inapplicable. In this situation, an MNE may consider using the CPM, which is less dependent on similarity between the controlled and uncontrolled service transactions than the CUP Method. As stated in 4.4.2.1, the financial ratio considered under the CPM is the gross profit mark-up. The aim of the CPM is to set the appropriate cost plus mark-up on the cost base so that the gross profit in a controlled services transaction is appropriate in light of the functions performed, risks assumed, assets used or contributed and market conditions. The CPM focuses on the service provider as the tested party. The CPM is used to determine arm's length service charges based on the gross profit mark-up on costs earned by comparable independent service providers. The CPM is often used for determining transfer prices for services.

5.4.3.2 Although the CPM is less dependent on similarity between the controlled and uncontrolled services under the CUP Method, the services in controlled transactions and comparable uncontrolled transactions should be similar. If material differences arise between the controlled transactions and the comparables, adjustments are required provided they are reasonably accurate.

5.4.3.3 The cost base of services for controlled and uncontrolled transactions should be comparable. The application of the CPM depends on ensuring that the cost base of the associated enterprise and the comparables are the same as there is the possibility of differences between the cost bases arising from the use of different indirect expenses in the cost base. A list of the types of direct and indirect costs is set out below at 5.4.4.1. Differences between the cost bases can arise from the use of different indirect expenses in the cost and may make the CPM unreliable.

5.4.3.4 While in principle the appropriate mark-up for the CPM should be based on available comparables from independent service providers, as a matter of simplicity it may be appropriate to use the safe-harbour option for low value-added services (such as administrative services) considered at section 5.5.2 below. The cost of finding appropriate comparables for the purposes of the CPM may be disproportionate to the tax liability at stake and thus the safe harbour provides a compromise that limits compliance costs and imposes an appropriate fixed mark-up. In addition, the task of finding comparable gross profit margins may prove challenging in many jurisdictions, as gross profit margins are not reported.

5.4.4 Total Service Costs: Direct and Indirect Costs

5.4.4.1 Total services costs means all costs included in calculating the operating income. The items that would be expected to be included in the direct cost base are: salaries of the staff providing services; bonuses; travel expenses; materials used in providing services; and communication expenses attributable to the provision of services. Indirect expenses may include the following items: depreciation of equipment and buildings; rent for leased items or immovable property; property taxes; occupancy and other overhead costs; maintenance costs; insurance; personnel costs, accounting and payroll expenses; and other general, administrative and managerial expenses. Total services costs do not include interest expenses, foreign income taxes or domestic income taxes.

5.4.4.2 **Example 12: On-call Group Services**

5.4.5 Transactional Net Margin Method (TNMM)

> A company that is a member of an MNE provides an on-call service to its associated enterprises and the service satisfies the economic benefit test. Once it is established that an on-call service provides a benefit to group members the next issue for consideration is the service fee that may be charged. The fee for an on-call service may include part of the capital costs of providing the service, such as business premises and equipment as well as a profit margin. If the premises and equipment are leased, the charge would be a proportion of the annual lease fees. If the premises and equipment are purchased, it would be appropriate to allocate depreciation expenses to the recipients. An independent enterprise providing such services would be expected to consider these expenses in the prices it charges its customers.

5.4.5.1 The TNMM may be used for services (see 4.5 for more details on the TNMM). The TNMM examines the net profit margin of an associated enterprise (the tested party) from the controlled transactions, relative to an appropriate base. The TNMM focuses on net profit rather than gross profit margins and looks at comparable net profit margins for uncontrolled transactions. The TNMM may be based on internal comparables, such as those from uncontrolled transactions into which the associated enterprise enters. Alternatively, the profit margins may be obtained from transactions by independent parties.

5.4.5.2 The TNMM may be used for intragroup services if the CPM cannot be used because reliable information on gross profit margins is unavailable for comparable service providers or because the cost base used for controlled and uncontrolled transactions is different. As the method is based on net profit levels, the TNMM has a greater tolerance for accounting inconsistencies arising from cost base differences between controlled and independent service providers.

5.4.5.3 The profit level indicator that may often be appropriate for intragroup services provided by an associated enterprise would be the ratio of the operating profit to the cost base of providing the services, referred to as the "Return on Total Services Costs". The Return on Total Services Costs earned by independent service providers carrying on comparable activities may be available and may provide reliable comparables to be used in applying the TNMM.

5.4.5.4 **Example 13: Marketing Services**

Service Provider Co. in Country A is a member of an MNE and it provides marketing services for the group. Service Provider Co. is requested by an associated enterprise Seller Co. in Country B to design a marketing programme for a new product. Following research, Service Provider Co. has concluded that the CUP Method and the CPM are inapplicable. In applying the TNMM to Service Provider Co., the costs of providing services and operating expenses are known. The unknown variable is the arm's length charge for the intragroup service.

A comparability analysis is then carried out to determine the appropriate arm's length net profit margin for Service Provider Co. If we assume that the direct costs of providing the service are $80,000 and the associated operating expenses are $20,000, the total direct and indirect costs of providing the services are $100,000. Assume that Service Provider Co. makes a net profit to costs ratio of 5 per cent.

A search of comparable independent marketing enterprises has revealed they are reporting a net profit to costs of providing services of three to eight per cent. Country A accepts the range of indicative comparables. The comparables are marketing enterprises which are listed on the stock exchange in Country A and provide similar marketing services to those provided by Service Provider Co. In this situation, Service Provider Co.'s net profit of 5 per cent is within the arm's length range of the net profit to the cost of providing the services. The service provider is treated as making a net profit of $5,000 from providing intragroup services to an associated enterprise.

5.4.6 Profit Split Method

5.4.6.1 The Profit Split Method may in certain circumstances be used for services (see 4.6 for more details on the Profit Split Method). The Profit Split Method is a two-sided analysis which applies to the profits of two or more associated enterprises engaging in controlled transactions. The Profit Split Method may be the most appropriate method when both sides to controlled transactions make unique and valuable contributions to the transaction, e.g. in the form of unique and valuable intangibles; in cases where the business operations of the parties are highly integrated; or where the parties share the assumption of economically significant risks. The aim of this method is to allocate profits on the basis that independent enterprises would have used in comparable independent transactions. Profits would be split on an economically rational basis that would reflect the relative value of functions performed, risks assumed and assets used or contributed by each associated enterprise. The Profit Split Method may be applied on the basis of a contribution analysis or a residual analysis (see section 4.6.4 for further elaboration).

5.4.6.2 **Example 14: Service Provider with Highly Integrated Operational Subsidiaries**

YZ Corporation is an MNE group engaged in the business of a logistics service provider offering a comprehensive portfolio of international, domestic and specified freight handling services. The group has two operating entities, Companies Y and Z, operating in country Y and country Z, respectively. The business activities of Y and Z involve entering into contracts with third parties for moving their cargo from its source to destinations abroad. The execution of the job involves lifting cargo from the location of the customer in one country, sending it to the country of destination, collecting it from a port or airport and then supplying it to the ultimate buyer.

Companies Y and Z undertake all the relevant activities in their own territories and do so in a highly integrated manner. Companies Y and Z are highly interdependent for the performance of all customer contracts since customers may be based in (and contract with) either Company Y or Company Z. The two entities also perform similar marketing, sales and customer relationship functions, and they have jointly developed and operate an integrated cargo tracking system. YZ Corporation markets itself to customers on the basis that its network of subsidiaries provides seamless integration across jurisdictional boundaries to customers, irrespective of their location.

In this example, the business operations of Company Y and Company Z are highly integrated and interdependent, such that neither could be reliably evaluated in isolation from the other. As a result, the Profit Split Method is found to be the most appropriate method in this case. The method might be applied by combining the total expenses incurred in all countries and then deducting these from total gross receipts, the residual amount being shared in the ratio of 50:50 between Company Y and Company Z.

5.4.7 Pass-through Costs

5.4.7.1 In some circumstances an MNE may decide to outsource some services to an independent entity with one associated enterprise acting as an agent for the group to pay the accounts and to then allocate the charges to its associated enterprises. Such costs may be called pass-through costs. As an agent, the associated enterprise's only role may be to pay the independent service provider and to then allocate the total cost of services among group members on an objective basis. In such a case, it may not be appropriate that the associated enterprise receives a mark-up on the cost of the outsourced services. Rather, the agent's compensation could be based on the costs of the agency function itself and the outsourced costs could be allocated among members of the MNE without mark-up.

5.4.7.2 **Example 15: Human Resource and Personnel Services**

An MNE has a parent company, Controller Company, in Country A and has an associated enterprise, Subsidiary Company in Country B. Controller Co. has 10 subsidiaries in total around the world. The MNE has reviewed its operations and has decided that the activities in which it has a comparative advantage will remain in-house functions and to outsource activities that independent enterprises can provide at a lower cost. The MNE has decided to outsource its human resources activities to an independent enterprise, Independent Company, in Country B, for the whole group. The MNE has decided to outsource the work through Subsidiary Company as it is located in the same jurisdiction as the service provider. The role of Subsidiary Company is to pay the independent enterprise and to recharge the costs it incurs in doing so to group members. In this situation Subsidiary Company is operating as an agent. Subsidiary Company passes on the service costs charged by Independent Company without a profit mark-up to MNE members using an allocation key based on full time employee equivalents. The charge is on a pass-through basis as Subsidiary Company is not adding value and is merely used for convenience to distribute the human resource costs of outsourcing to Independent Company. In addition, Subsidiary Company may provide a service in paying Independent Company and allocating the cost to MNE members.

5.4.8 Allocation Keys

5.4.8.1 The use of allocation keys can provide an effective proxy for estimating the proportional share in the expected benefits from the activities, and accordingly for allocating the costs or value of services within an MNE, once the benefit test has been satisfied. An allocation key should be determined consistently for all associated enterprises concerned and should reasonably reflect each associated enterprise's relative share in the expected benefits from the intragroup services. An example of an inconsistent allocation key is one that uses different bases for allocating expenses for services to associated enterprises in different tax jurisdictions.

5.4.8.2 When selecting an allocation key, consideration should be given to the nature of the services and the use to which the services are put. For example, if the services relate to human resource activities, the proportionate number of employees may be an appropriate measure of the respective benefit to each MNE member. In addition, there are situations in which the proportion of services rendered to each beneficiary might not be easily identifiable with reference to the exact quantum of benefit attained or expected (for instance, in cases involving a centralized advertisement campaign). In such cases, the allocation key would be an approximate value (e.g. proportional net sales of all the beneficiaries to allocate the cost incurred to implement the centralized advertising campaign mentioned above).

5.4.8.3 From a compliance perspective, there is a trade-off between precision and simplicity. A complex allocation key may place an excessive compliance burden on MNEs with negligible improvements in allocating expenses within an MNE. Any allocation will benefit from having supporting evidence to justify that it allocates expenses within an MNE on an appropriate basis. Determining whether an allocation key is appropriate requires an analysis of an MNE's facts and circumstances.

5.4.8.4 In order to comply with the arm's length principle, an allocation key should satisfy the following requirements:

- Be measurable;
- Be relevant to the type of services, i.e. provide a reasonable proxy for measuring the parties' proportional share in the expected benefits from the services at hand;
- Be determined consistently within an MNE; and
- Be documented.

Furthermore, care should be used where the allocation key is significantly affected by other intragroup transactions. For example, allocating service costs on the basis of the proportional third-party and related party sales of the associated enterprises receiving the services may not be appropriate if some of those associated enterprises make a large percentage of their sales to associated enterprises. This is because prices of the latter may be subject to adjustment under transfer pricing rules.

5.4.8.5 Examples of allocation keys include:

- Sales;
- Gross or net profit;
- Units produced or sold;
- Number of employees or full-time equivalents (FTEs);
- Value of salaries and wages;
- Number of information technology users;
- Office or factory space;
- Capital;
- Operating expenses; and
- The number of personal computers, tablets or other devices.

5.4.8.6 The following non-exhaustive list contains allocation keys that are commonly used by MNEs for certain types of services:[52] (see also the example in Annex 1 of 5.14.4):

- Information technology: number of personal computers, tablets or other devices; number of users;
- Business management software: number of licences;
- Human resources: number of employees;
- Health and safety: number of employees;
- Staff training: number of employees;
- Tax and accounting: sales or size of balance sheet;
- Marketing services: value of sales to independent customers; and
- Vehicle fleet management: number of cars; distance travelled.

These allocation keys are provided only as examples and other allocation keys may be acceptable.

5.4.8.7 **Example 16: Use of HR Allocation Key**

Manufacturing Co., Distributor Co. and Personnel Co. are associated enterprises in an MNE. Manufacturing Co. is the parent company and is resident in Country A. Distributor Co. is resident in Country B. Manufacturing Co. is in the business of manufacturing sporting goods. Distributor Co.'s only business activity is to distribute Manufacturing Co.'s goods in Country B. Personnel Co. is resident in Country C and provides human resources services for the group.

The centralization of services is designed to exploit efficiencies of scale and the relatively lower labour costs in Country C. Assume that Personnel Co.'s total cost of providing human resources services to Manufacturing Co. and Distributor Co. is $454,545. Assume that a 10 per cent mark-up is found to be arm's length. The cost base includes direct and indirect costs in accordance with the accounting standards used in Country C. Therefore, the total service charge for human resources services provided to Manufacturing Co. and Distributor Co. is $500,000. Manufacturing Co. has 1,000 employees and Distributor Co. has 50 employees. These are

[52] EC (2011). *Guidelines on Low Value Adding Intra-group Services.* Brussels: EC. Available from https://ec.europa.eu/taxation_customs/system/files/2016-09/c_2011_16_en.pdf.

full-time equivalent employees. This MNE group uses an allocation key for attributing the human resource service charge on the basis of number of employees. This allocation key is chosen as it reflects the expected benefits of the associated enterprises from the provision of intragroup human resources services. The cost to be allocated per employee is ($500,000/1,050) $476.19. On this basis, the allocation key results in the following allocation of the human resources service charge:

- Manufacturing Co.: 1,000 employees, $476,190.00;
- Distributor Co.: 50 employees, $23,809.50.

5.5 Safe Harbours

5.5.1 Introduction

5.5.1.1 It is often burdensome and costly to determine arm's length prices if an associated enterprise provides a range of intragroup services. A practical alternative for a tax authority is to provide taxpayers with the option of using a safe harbour for certain low value-adding services, provided it results in an outcome that broadly complies with the arm's length principle. The safe harbour may be based on acceptable mark-up rates for services. Several countries provide a safe harbour option for certain services. The advantages of a safe harbour are that it provides certainty for taxpayers and tax authorities. In addition, safe harbours can reduce the costs of complying with transfer pricing requirements in a country. Moreover, any additional tax revenue that a tax authority may receive from a transfer pricing adjustment of such services may be outweighed by the administrative costs of applying the arm's length principle to such services. Accordingly, providing a safe harbour enables tax authorities to use their resources to concentrate on transfer pricing reviews in which the tax revenue at stake is more significant. The downside of a unilateral safe harbour is that the service provider's country may not provide for a safe harbour and insist on a higher mark-up than the safe harbour mark-up and this may result in double taxation. If a bilateral or multilateral safe harbour is Wavailable, this is to be preferred as it reduces the risk of double taxation.

5.5.1.2 This chapter sets out two safe harbours that may be used by tax authorities:

- Low value services that are unconnected to an associated enterprise's main business activity. This safe harbour is usually available for low value-adding services. The rationale for a safe harbour is that there may be difficulties in finding comparable transactions for low value-adding services; and the administrative costs and compliance costs may be disproportionate to the tax at stake. In addition, the safe harbour provides taxpayers and tax authorities with certainty.

- Safe harbours for minor expenses (i.e. amounts below a defined threshold). These are for situations in which the costs of services provided or received are relatively low, so the tax authority may agree to not adjust the transfer prices provided they fall within the acceptable range. The rationale for this safe harbour is that the cost of a tax authority making adjustments is not commensurate with the tax revenue at stake and therefore the taxpayer should not be expected to incur compliance costs to determine more precise arm's length prices.[53]

5.5.2 Low Value-adding Services Safe Harbour

5.5.2.1 Low value-adding services are services which are not part of an MNE group's main business activities from which it derives its profits. They are low value-adding services that support the associated enterprise's business operations. A determination of an associated enterprise's low value-adding services would be based on a functional analysis of the enterprise. The functional analysis would provide evidence of the main business activities of an associated enterprise and the way in which it derives its profits.

5.5.2.2 Low value-adding intragroup services are services performed by one member or more than one member of an MNE group on behalf of one or more other group members which:

- Are of a supportive nature;
- Are not part of the core business of the MNE group (i.e. not creating the profit-earning activities or contributing to economically significant activities of the MNE group);
- Do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and
- Do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.

[53] These two safe harbours are based on the safe harbours in the Australian Taxation Office's Taxation Ruling 1999/1 *Income Tax: International transfer pricing for intra-group services*, paras. 77–87. Available from https://www.ato.gov.au/law/view/document?src=hs&pit=99991231235958&arc=false&start=1&pageSize=50&total=123&num=10&docid=TXR%2FTR19991%2FNAT%2FATO%2F00001&dc=false&stype=find&tm=phrase-basic-1999%2F1

5.5.2.3 The following services are common examples of low value-adding services for most MNE groups (i.e. provided they do not constitute the core business of the group):

- ➢ Human resources services;
- ➢ Accounting services;
- ➢ Clerical or administrative services;
- ➢ Tax compliance services; and
- ➢ Data processing.

See also Annex 1 for the list of low value-adding services compiled by the European Commission.

5.5.2.4 For an associated enterprise that is a distributor and marketer of an MNE's products, marketing services would fail to qualify as administrative services as they are directly connected to the enterprise's main business activity. Similarly, for an MNE whose core business was recruitment and human resources management, human resources services of a kind similar to those provided to independent customers would not qualify for the low value-adding safe harbour despite the mention of human resources services in the section above.

5.5.2.5 The following services are examples of services that would typically fail to qualify as low value-adding services:

- ➢ Services connected with main business functions performed by an MNE;
- ➢ Extraction and exploration services;
- ➢ Manufacturing services;
- ➢ Construction services;
- ➢ Financial services;
- ➢ Research and development services;
- ➢ Marketing and distribution services; and
- ➢ Strategic management services.

5.5.2.6 The determination of whether services qualify as low value-adding services may require a case-by-case analysis of the key business activities of an MNE.

5.5.2.7 A safe harbour may contain the following requirements:

- ➢ Identification of the service within the scope of the safe harbour;
- ➢ A fixed profit margin;

- An assumption that the same profit margin is accepted in the other country; and
- Documentation requirements.

5.5.2.8 **Example 17: Safe Harbour for Low Value-Adding Services**

Manufacturing Co., Distributor Co. and Services Co. are associated enterprises. Manufacturing Co. is resident in Country A and carries on the business of manufacturing goods. Distributor Co. is resident in Country B and is a distributor of goods purchased from Manufacturing Co. The MNE group decides to centralize its human resources function in Services Co. in Country C in order to obtain cost savings through economies of scale and the relatively low labour costs in that country. The total cost of human resources services provided to Distributor Co. is $100,000 under a direct charging system and the agreed mark-up for this function is 7.5 per cent in Country C; therefore Distributor Co. is charged $107,500 by Services Co. under a direct charging system for human resources services. Distributor Co. has total deductions of $2 million which include the services costs for Services Co. Country B provides an administrative safe harbour for low value-adding inbound and outbound intragroup services.

Under the safe harbour provisions, a profit mark-up of 7.5 per cent is allowable. A further requirement of the safe harbour is that the total expenses claimed under the safe harbour cannot exceed 15 per cent of the taxpayer's total deductions. Distributor Co. chooses to use the safe harbour for low value-adding administrative services and claims a deduction of $107,500. Distributor Co. has documentation that it received human resources services from Services Co. and that it used the low value-adding services safe harbour.

On the facts, Distributor Co. would be entitled to use the low value-adding services safe harbour as the human resources are less than 15 per cent of its total expenses and the mark-up on services is in accordance with the safe harbour requirements. On the basis that Distributor Co.'s main business activity is distributing goods, human resources services would qualify as administrative services.

5.5.3 Minor Expense Safe Harbour

5.5.3.1 In the minor expense safe harbour option, a tax authority agrees to refrain from making a transfer pricing adjustment if the total cost of either receiving or providing intragroup services by an associated enterprise is below a fixed threshold based on cost and a fixed profit mark-up margin is used.

5.5.3.2 The aim is to exclude from transfer pricing examinations services for which the charge is relatively minor. The rationale is that the costs of complying with the transfer pricing rules would outweigh any revenue at stake. It also considers the potential administrative savings for a tax authority by avoiding transfer pricing examinations of minor expenses. An important requirement is that the same fixed profit margin should be used for inbound and outbound intragroup services for a country. The safe harbour provides taxpayers and tax authorities with certainty. The minor expense safe harbour may contain the following requirements:

- A restriction on the relative value of the service expense (e.g. less than X per cent of total expenses of the associated enterprise receiving the services) or alternatively, a restriction on the absolute value of the service expense;
- A fixed profit margin;
- The requirement that the same profit margin is used in the other country; and
- The documentation requirements that are expected.

5.5.3.3 An example of a safe harbour for services is set out as follows.

For inbound intragroup services:

- The total cost of the services provided is less than X per cent of the total deductions of the associated enterprises in a jurisdiction for a tax year, or less than a defined absolute amount in the local currency;
- The transfer price is a fixed profit mark-up on total costs of the services (direct and indirect expenses); and
- Documentation is prepared to establish that the safe harbour requirements have been satisfied.

For outbound intragroup services:

- The cost of providing the services is not more than X per cent of the taxable income of the associated enterprise providing the services, or not more than a defined absolute amount in the local currency;
- The transfer price charged is based on a fixed profit mark-up on the total costs of the services (direct and indirect expenses);

- The same profit margin is used in the other country; and
- Documentation is created to establish that these safe harbour requirements have been satisfied.

5.5.3.4 **Example 18: Safe Harbour Rule for Minor Expenses**

> Assume that Subsidiary Co. is resident in Country A and receives marketing services from its parent company, Parent Co., which is resident in Country B. A minor expense safe harbour is available in Country A. Under the Country A provisions, services expenses can qualify for the safe harbour if they total less than $750,000 and constitute less than 15 per cent of total deductible expenses. A profit mark-up on direct and indirect costs of up to 7.5 per cent is allowable under the safe harbour rules. The total direct and indirect cost of providing the services is $500,000.
>
> Subsidiary Co. decides to use the safe harbour option, as the costs of preparing a comprehensive transfer pricing analysis for such services and determining the arm's length margin would be excessive given the materiality of the services concerned. Subsidiary Co. does not acquire other services from associated enterprises and its total deductible expenses are $10 million. The total charge for services of $537,500 is below the $750,000 threshold and the expense is 5.37 per cent of Subsidiary Co's total deductible expenses and thus below the 15 per cent threshold. Accordingly, provided Subsidiary Co. satisfies the relevant documentation requirements, it can deduct the $537,500 amount paid to Parent Co under the safe harbour rules.

5.5.3.5 Safe harbours may have unintended consequences and should be carefully considered before they are implemented. If in the above example a full transfer pricing analysis concluded that the arm's length profit margin is 5 per cent, the service charge would have been $525,000. Under the safe harbour, Subsidiary Co. has been able to claim $537,500 as a deductible expense in Country A for intragroup services. Moreover, Subsidiary Co has not had to incur the costs of a full transfer pricing analysis (which may have exceeded $12,500).

5.5.3.6 On the other hand, if the tax authorities in Country B are not aware of the safe harbour, the application of the Country B transfer pricing rules would require arm's length services income of $525,000 to be reported, which is $12,500 less than the amount claimed as a deductible expense by Subsidiary Co. in Country A, effectively creating an amount of income that is not subject to tax in either country. To avoid this result, consideration should be given to requiring a matching of income and costs under the safe harbour rules. Ideally, safe harbours should also be considered on a bilateral or multilateral basis.

5.6 Group Procurement Activities: An Illustration of the Operation of the Rules on Services

5.6.1 This section provides additional guidance on how to analyze centralized procurement activities in an MNE, the factors that may affect compensation for those activities, and the transfer pricing methods that may be appropriate.

5.6.2 Additional guidance is appropriate because most MNEs operate some form of centralized procurement function, but the precise nature of the activities and their contribution to value can vary widely. This guidance helps to identify the functions that may be involved in centralized procurement activities, and the factors that can distinguish lower contributions to value from higher contributions. Developing countries sometimes encounter aggressive arrangements involving the insertion by an MNE of procurement activities that seem to lack economic substance; in illustrating the commercial objectives of centralized procurement activities and typical functions, this guidance should help to identify features of substantive arrangements.

5.6.3 Procurement activities may attract the interest of tax administrations. These activities are among those specified for disclosure in a country-by-country Report[54] and are the subject of attention by the Forum on Tax Administration in its Handbook on Effective Tax Risk Assessment, where procurement is seen as a potentially mobile activity that could be located in jurisdictions where the group does not have significant manufacturing operations (i.e. the key markets for the procured goods) and used to reduce the level of taxable income in the jurisdictions where goods are processed or sold.[55] Offshore procurement is identified as an activity to be noted in a risk assessment for further examination at 13.2.2.16.

5.6.4 However, procurement activities may be located outside key markets

[54] OECD (2015). *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13-2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project. Paris: OECD Publishing. Available from https://www.oecd.org/ctp/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report-9789264241480-en.htm

[55] OECD (2017). *Country-by-Country Reporting: Handbook on Effective Tax Risk Assessment*. Paris: OECD Publishing. Available from https://www.oecd.org/tax/beps/country-by-country-reporting-handbook-on-effective-tax-risk-assessment.pdf. See paras. 70–71.

because the activity, or some element of it, needs to be conducted in close proximity to the sources of supply. For some industrial sectors, including clothing or food ingredients as examples, those sources of supply may be in developing countries for whom the products may represent a significant proportion of export trade. Therefore, incorrectly evaluating procurement activities can have detrimental tax consequences for both the jurisdiction in which the activity generates income and the jurisdiction being charged a fee. This guidance provides a framework in which to evaluate procurement activities, irrespective of their location, and its application is illustrated by an extended example at the end of the section (see section 5.14.4).

5.7 Cost-savings Issues Arising from Centralized Procurement Functions

5.7.1 Centralized procurement activities are often associated with cost savings, which is usually taken to mean per unit cost reductions of the goods or services procured. However, as the following section explains (see 5.8.), there may be many commercial objectives driving the centralizing of procurement activities within an MNE, and per unit cost savings may not always be one of them. Procurement activities can and do provide value in ways other than per unit cost reductions.

5.7.2 Where evidence of per unit cost reductions is provided by a taxpayer, the impact of any volume effect will need to be considered, but it is important not to jump to the conclusion that the reductions are caused solely or partly by a volume effect. A supplier will not always be willing or able to reduce the price in exchange for higher volumes, and the associated enterprises individually may already have sufficient volume to command the lowest price. In the absence of a published price list, it will be difficult for tax administrations to assess whether additional volume has caused additional discount. There may be countervailing commercial pressures as well that drive a buyer to adopt a multiple sourcing strategy and to spread its volume around multiple vendors and reduce risk exposure, and similarly that may drive a vendor to avoid over-reliance on one customer.

5.7.3 Evidence of per unit cost reductions may point not to a potential volume effect, but rather to the interaction of the procurement activities with the vendor that helps to reduce the vendor's costs or risks which can then partly be passed on to the buyer: for example, a procurement company might take on transport coordination functions, or assume compliance with labelling requirements. Significantly, procurement activities could be found to include arranging for a range of products to be sourced from a particular vendor; some seasonal, time sensitive, and with unpredictable demand; and some predictable items that can be produced throughout the year, so that the vendor can plan production schedules more efficiently and reduce or eliminate down-time and associated costs. A reduction in the vendor's risks and costs in this manner can drive a more favourable price for the buyer. In such a case, volume itself may play little or no part in achieving the cost reductions for the buyer; instead the cost reductions are achieved through the expert coordination of both vendor and buyer requirements by the party providing the procurement activities.

5.7.4 Measurement of per unit cost savings is sometimes used in evaluating the fee for procurement activities, as discussed further in section 5.14. This can be a difficult measurement for tax administrations to analyze. It may be possible to see that in Month 12 an MNE was paying 100 for an item, and that in Month 13 following the introduction of a centralized group procurement company, the MNE was paying 95 for the identical item on the same terms. But as time passes, the relevance of using 100 as the base-line reduces because other factors may have contributed to price changes, and the item may no longer be identical. In such cases, measurement of cost savings in, say, Month 37 may be presented by the taxpayer based on comparison with a hypothetical price that the MNE would have paid in Month 37 had it not received the services of the group procurement company. The hypothesis will need to be presented rigorously by the taxpayer with supporting evidence, and verification ultimately may be difficult for tax administrations. Thus, where cost savings are relevant to evaluating a fee for procurement activities they need to be supported by evidence that can be examined by tax administrations. It should not be forgotten that procurement activities can provide value in the absence of per unit cost reductions.

5.7.5 In practice, the MNE may monitor and measure in various ways the performance of procurement activities for commercial purposes in order to assess their effectiveness, and those measures may be instructive in a transfer pricing analysis. Depending on the commercial objectives of the MNE, such monitoring and measurement may focus on quality, speed, standardizing the range of items, finding alternative sources of supply, working capital management through vendor credit terms and inventory levels, order processing costs, production disruption, integrating other divisions or newly acquired businesses, meeting external and internal standards (for example, ethical trading, traceability, safety), and specific improvement projects to which the procurement function contributes.

5.8 Commercial Objectives In Centralizing Procurement Functions

5.8.1 There may be various commercial objectives in centralizing procurement activities. A pure volume effect may not be the most important objective, particularly when individual enterprises in an MNE may separately have strong buying power. At its simplest level centralizing can reduce administrative costs by coordinating and aggregating purchase orders, so that instead of, say, 25 associated enterprises in an MNE, each separately purchasing from, say, 10suppliers, thereby creating 250 orders each time, the purchase orders are aggregated, so that there is only one order placed with each of the 10 suppliers. However, at this simple level, the individual members of the MNE group continue to determine their requirements, and the central procurement activity helps to manage and reduce the administrative costs of order processing and accounts payable.

5.8.2 An additional commercial objective of centralizing procurement activities might be to standardize buying terms; it may be that the 25 enterprises had each negotiated different terms with the suppliers in the past, and the oversight of all purchasing that central coordination can bring enables a sharing of the best terms for all associated enterprises. The central procurement function remains administrative; it is not itself creating enhanced terms but acting as the vehicle through which the members of the MNE share information and best practice. In some circumstances, dealing with one buyer may be helpful for the supplier since it is no longer dealing with 25 different buyers and may be able to share efficiencies with the MNE that arise through reduction in numbers of purchase orders, standardization of terms, and coordinated production scheduling and delivery.

5.8.3 In some industries, for example producers or users of energy products, centralizing procurement activities may be a response to the significant infrastructure costs required to perform the procurement activities. Such costs may involve electronic trading platforms and may also extend to transportation and storage assets. A key commercial objective in centralizing procurement activities in such cases is to make the most efficient use of the investment.

5.8.4 In other situations, the centralizing of procurement activities may be established, or may evolve, to take a more active and extensive role in managing procurement and sourcing for the MNE with the objective of improving the group's profitability and managing its risks. The role may be directed to enhancing the relationship with vendors, to improving the performance of the associated enterprises requiring the goods or services, or both.

5.8.5 A skilled buying team will likely analyze the supply chain and seek to rationalize excessive numbers of vendors without creating unacceptable exposure to a particular supplier, region, or currency; seek to deepen the relationship with remaining vendors through collaboration in managing production scheduling, demand forecasting, and specification improvements;

monitor quality; select better or alternative sources of supply; and continually assess global trends that may affect availability of supply and prices. A skilled buying team may also seek to understand and anticipate the requirements of the associated enterprises using the goods or services.

5.8.6 The buying team may work closely with the production teams or development teams of the associated enterprises so that the buying team can suggest alternative or cheaper components, and will seek to understand and contribute to scheduling forecasts in order to avoid the costs and risks of over-stocking as well as the potentially greater costs and risks of having insufficient supply.

5.8.7 In some sectors there are regulatory requirements concerning traceability of items used in producing goods, and there may be consumer interest in sustainability, environmental impact, and ethical concerns which can have consequences for the reputation and ultimate success of the MNE. The central procurement and sourcing function may have the commercial objective of coordinating or leading the efforts of the MNE in these matters.

5.8.8 In fulfilling these more active and extensive roles, the central procurement activities are not simply administrative, but have the commercial objective of improving the performance of the MNE's operations. Since such an objective for active and extensive procurement activities carries the potential for a higher evaluation of the arm's length compensation, a more detailed explanation of the extent of the activities and how they contribute to the MNE's performance should be covered in the taxpayer's transfer pricing documentation.

5.9 Evaluating Compensation for Procurement Activities

5.9.1 Any evaluation of the compensation for centralized procurement activities in an MNE should be based on a thorough understanding of the accurately delineated transaction, as set out in section 3.3.2 of this Manual. Three matters are likely to be particularly important to understand: (i) the role and expertise of a procurement services provider; (ii) the nature of the items procured and the commercial risks associated with those items; and (iii) any risks that a service provider assumes. These matters are discussed in the following sections.

5.10 The Role and Expertise of the Procurement Services Provider

5.10.1 Procurement activities cover a range of functions and the particular functions actually performed in a particular case need to be specifically identified and their commercial objectives and contribution assessed. In performing such an analysis, it can be helpful to consider two categories of functions relating to procurement: purchasing and sourcing.

5.10.2 In providing a purchasing service, a centralized group procurement company may be instructed by the associated enterprises about their requirements, and the instructions may include specifications for the product or service, identification of the vendors, and parameters for volumes, pricing, delivery scheduling and other terms. In performing such a purchasing function, a group procurement company may provide "execution only," and it may perform a largely administrative function relating to raising purchase orders and managing accounts payable. The role may not require expertise about the products or services procured, the needs of the recipients, or the capabilities of the vendors. The role of centralized purchasing might include relaying revised terms or other proposals to the recipients for approval, but it might not actively seek improvements or alternatives. The commercial objectives of a centralized purchasing function may include those outlined at 5.8.1 and 5.8.2.

5.10.3 A sourcing role is more extensive. The role of the centralized procurement company in performing a sourcing function may involve working with the associated recipient enterprises jointly to draw up specifications, to explore alternative specifications, identify potential sources of supply taking into account advantages and disadvantages of particular sourcing strategies, work with vendors to understand their capabilities and options, propose a supply schedule and other terms taking into account production forecasts. Such a role may require expertise about the products or services procured, the needs of the recipients, and the capabilities of vendors. It is not an "execution-only" administrative role, but determines the sourcing strategy, and involves vendor management and demand forecasting. In addition to specialized know-how, such a sourcing activity may use proprietary software tools to evaluate vendors and manage supply scheduling and inventory levels. The commercial objectives of a centralized sourcing function may include those outlined in 5.8.4 and 5.8.5.

5.10.4 Functionality and expertise are greater in a sourcing activity than in an activity that is limited to purchasing. As a result, purchasing and sourcing would generally be more valuable to the recipient enterprises than a purchasing only service, and would be expected to command higher compensation than that for purchasing alone. Therefore, in evaluating a particular controlled transaction involving procurement activities, it is useful to properly understand the scope of purchasing activities and the scope of any sourcing activities.

5.10.5 Although purchasing functions have been considered separately to sourcing functions to highlight differences that may affect levels of compensation, in practice activities may include aspects of both categories. For example, a purchasing function may include aspects of sourcing activities with the result that the activity is not simply "execution-only," and would thus generally be more valuable to the recipient enterprises in such a case than an activity limited to purchasing.

5.11 The Nature of the Items Procured and the Commercial Risks Associated with Those Items

5.11.1 It is important to determine through the accurate delineation of the actual transaction whether the goods or services procured by the centralized procurement company constitute core spend or non-core spend for the recipient associated enterprises. Non-core spend, sometimes referred to as indirect spend, covers goods and services that support the businesses of the recipient associated enterprises and are not themselves converted into a finished item or resold. Core spend, sometimes referred to as direct spend, involves items that are converted or resold in the course of the business of the recipient associated enterprises.

5.11.2 In the case of non-core spend, for example, stationery, office equipment, telephone services, vans, or media space, an important factor that needs to be tested in accurately delineating the actual transaction is that the goods or services are unlikely to be a key risk for the recipient or a significant contributor to business performance. The goods and services are likely to be available from a range of suppliers, and so the pricing is already competitive. Specifications are likely to be relatively standardized and options for changes or improvements may be limited. The function of the centralized procurement company in the case of non-core spend may be largely that of a coordinator and aggregator, with the main commercial benefits being the combining of purchasing power across the MNE and efficiencies in reducing administrative costs for the MNE.

5.11.3 However, in the case of spend on core, business-critical items, for example, lithium for a lithium-ion battery manufacturer, certain ingredients for a food manufacturer, or energy for a smelter, an important factor that needs to be tested in accurately delineating the actual transaction is that the goods or services may represent a significant contribution to business performance and be associated with significant risks. The items may have very limited sources, availability of supply may be unpredictable, prices may be volatile, and there may be particular specifications to be met or worked around. The function of the centralized procurement company in the case of core spend may require specialized expertise and may involve mitigation of critical business risks for the recipient associated enterprises.

5.11.4 These factors suggest that procurement of goods and services constituting business critical core spend for the recipient associated enterprises would generally be more valuable to the recipient enterprises than procurement of goods and services constituting non-core spend, and, subject to thorough determination of the actual functions performed, assets used or contributed, and risks assumed in a specific controlled transaction, would generally be expected to command higher compensation than that for procurement of indirect spend.

5.12 Risks Assumed by the Group Procurement Company

5.12.1 Arguments are sometimes made that a centralized procurement company should have a high level of compensation because of the risks it claims to assume. While it is the case that the assumption of increased risk would be expected to be compensated by an increase in the anticipated return, careful attention may need to be paid when examining risk assumption by the associated enterprise performing centralized procurement activities.

5.12.2 It may be asserted that a centralized procurement company assumes, for example, risk associated with holding inventory (which may involve the risk of changes in the value of inventory owing to market price changes or obsolescence, or the risk of additional costs because of over-stocking), since it is the contracting party that buys the goods or services procured and is the contracting party that sells them to the recipient associated enterprises. The insertion of the centralized procurement company in the flow of goods or services is not likely to be a typical arrangement given the potential for additional cross-border movements and complexities of customs duties and additional transaction costs. In addition, vendors may require guarantees to be provided by the parent or associated enterprises in order to sell directly to a group procurement company that may present concerns about creditworthiness; in such a case, there may be additional intragroup transactions to be examined. Where inventory is determined to be owned by the centralized procurement company, evaluation of the risk is required. It will be relevant to determine whether the group procurement company takes "flash title" only under back-to-back arrangements with the associated recipient enterprises, thus significantly reducing or eliminating its inventory risk. In practice the recipient associated enterprises may compensate the centralized procurement company for any additional costs, thus insulating the centralized procurement company from the impact of inventory risk.

5.12.3 It will also be relevant to consider whether the supply arrangements with the vendors are flexible so that purchase volumes can be reduced as demand falls, thus reducing or eliminating risk. Nevertheless, if the centralized procurement company could suffer additional costs as a result of the impact of inventory risk it contractually assumes, then control of risk under the guidance at 3.4.4.32 to 3.4.4.35 needs to be determined. If the centralized procurement company does not control the inventory risk it contractually assumes because, for example, it does not determine quantities purchased, stocking levels, production scheduling, or manufacturing volumes, then it is unlikely to be allocated the risk under that guidance for transfer pricing purposes.

5.12.4 A centralized procurement company may assume contractually a range of other risks. In such cases a similar analysis to that described above under the guidance at 3.4.4.32 to 3.4.4.45 is required. A procurement company could claim to assume price risk by undertaking to guarantee a certain range of prices for the recipient associated enterprises, or to assume volume risk by undertaking to supply a certain volume. However, such risks may be reduced or eliminated if the terms agreed with the vendors in practice pass price or volume risk back to the vendors. A claim that a centralized procurement company is exposed to the full impact of cyclical demand and price risks should be examined carefully, as attention should be paid to whether it has the expertise to evaluate the risk, makes decisions in relation to the risk, and has the financial capacity to bear the risk.

5.12.5 Although the MNE procurement company may not assume risks associated with the goods and services procured, it will be necessary to determine whether the group procurement company performs control functions relating to risks assumed by associated enterprises, since such risk control functions need to be taken into account in determining the appropriate amount and form of the compensation (see 3.4.4.45). In the case of the sourcing of core, business-critical items, in particular, the accurate delineation of the actual transaction could show that availability of supply is a key risk for the MNE and that the group procurement company directly mitigates disruption risk through developing reliable sources of supply or exploring alternative specifications.

5.12.6 Thus, as a general matter, recipient associated enterprises would be prepared to pay more for a procurement service that reduces or eliminates their risks, but care needs to be taken to ascertain that risks have in fact been mitigated for the recipient associated enterprises, and that the group procurement company contributes to such mitigation by performing risk control functions.

5.12.7 A centralized procurement company may have its own risk associated with developing and maintaining proprietary tools, systems, know-how, and investment in physical assets.

5.13 Procurement from Associated Enterprises

5.13.1 It has been assumed in the foregoing that the most typical form of intragroup procurement activities involves procurement from independent vendors on behalf of recipient associated enterprises. It is possible, however, that an MNE may use a group procurement company to purchase from other associated enterprises in the group. The potential for reducing transaction costs and increasing efficiency through coordination and aggregation could apply in such a case for the MNE similarly to the situation described in section 5.8.1. Instead of dealing with 10 independent suppliers, as illustrated in that paragraph, the group procurement company could deal with 10 associated enterprises, but the efficiency effect of consolidating the ordering process and reducing the number of purchase orders continues to apply.

5.13.2 However, a claim that a group procurement company performs more than an administrative role when acting as an intermediary in purchasing from associated enterprises might not be supported by the evidence. A claim that a group procurement company performs a sourcing role, involving the selection and management of vendors which are in fact associated enterprises, is likely to be difficult to substantiate in the case of an integrated MNE in which associated enterprises are aware of each other's capabilities and are organized to fulfil a specific role in the MNE's supply chain. That supply chain may benefit from other centralized management activities, but any payment for finding a vendor that is already found and is part of the design of the MNE's supply chain would seem difficult to justify.

5.14 Pricing Methods

5.14.1 Overview

5.14.1.1 The general principles set out in this chapter relating to the pricing of intragroup services apply to pricing considerations for intragroup procurement services, including the application of the direct and indirect charging approaches (see 5.3.2). In general, where the centralized procurement activity provides services to multiple associated enterprises in the MNE, and the services to each associated enterprise can be separately analyzed and quantified, then a direct charge approach may be reliably applied. However, in many instances of centralized procurement activities that provide services to multiple associated enterprises, there may be no option but to use an indirect allocation of the fee to those associated enterprises. An appropriate allocation key may be based on respective values of goods or services procured for those associated enterprises. In applying an indirect allocation of the fee, care should be taken to ensure that all the associated enterprises receive the same kind of service. For example, it may be that the procurement activity provides a purchasing service for some associated enterprises but a purchasing and sourcing service for others; or it may be that the procurement activity relates to non-core spend for some associated enterprises but to core spend for others. In such instances, there may be different levels of fee required depending on the category of services. It is important that any indirect allocation of the fee takes these differences into account by, for instance, identifying the associated enterprises using the same category of services and allocating an indirect share of the fee relevant to that category of services only to those associated enterprises.

5.14.1.2 Given the range of activities that may be involved in procurement and sourcing activities, it is not surprising that a range of pricing structures is seen in arrangements with independent, outsourced procurement providers. These pricing structures range from a fee related to the provider's input costs, which may be particularly appropriate where the decision to outsource is motivated by a desire to reduce headcount and transfer people and associated costs to the outsourced provider; fees which are set as a percentage of managed spend (similar to a commission), and which may encourage investment by the service provider; to fees which are designed to incentivize the outsourced procurement provider by sharing gains. In practice hybrid fee structures may be seen, combining a commission on managed spend with a gain-share element.

5.14.1.3 When determining the pricing for centralized procurement activities within an MNE, transfer pricing methods can broadly mirror such industry pricing structures. Pricing based on costs, plus an arm's length mark-up under the CPM or TNMM, may be appropriate; or comparable commission rates under a CUP Method may be applied; or a form of benefits analysis may be constructed which requires the gains achieved as a result of the procurement activities to be measured and which then shares them between the centralized procurement company and the associated recipient enterprises.

5.14.1.4 As in any transfer pricing analysis, the appropriateness of the method depends crucially on the facts and circumstances of the controlled transaction and the reliability with which the method can be applied. These matters are discussed further below, but before doing so it is useful to remember that the application of one method rather than another method can yield significantly different results, especially if applied over a number of years.

5.14.2 Example of a Centralized Procurement Activity

5.14.2.1 The following facts are assumed, which shows the costs incurred in performing the activities ("own costs") and the costs of the goods or services procured through those activities ("managed spend"):

Table 5.T.1
Example of a Centralized Procurement Activity

	Year 1	**Year 2**	**Year 3**
Own costs (A)	$5m	$10m	$10m
Managed spend (B)	$200m	$800m	$1600m
Cost Plus approach			
Illustrative fee based on CPM (A plus 10 per cent mark-up)	$5.5m	$11m	$11m
Profit	$0.5m	$1m	$1m
Fee expressed as a percentage of B	2.75%	1.375%	0.6875%
CUP approach			
Illustrative fee based on CUP (B x 2 per cent commission)	$4m	$16m	$32m
Profit	($1m)	$6m	$22m
Fee expressed as a mark-up on A	N/A	160%	320%

For the purposes of the example, it is assumed that a CPM determines a mark-up of 10 per cent and that a CUP determines a commission on managed spend of 2 per cent.

5.14.2.2 In this example, there may have been some over-capacity or some investment in technology by the centralized procurement company in its initial year that meant a CUP Method results in a loss. However, as managed spend ramps up, the gap between profits under the CPM and profits under a CUP Method widens considerably. One method determines a 10 per cent mark-up on costs, the other method results in a 320 per cent mark-up; one method determines a commission of 2 per cent, the other method results in a commission of less than 1 per cent. Expressed another way, the recipient associated enterprises in Year 3 pay $32m to the centralized procurement company under one method and $11m under the other method. A high standard of evidence and analysis is usually required, therefore, to demonstrate that the centralized procurement company contributes sufficiently to business outcomes to justify the payment of that additional $21m. Because the choice of method can lead to widely different outcomes, disputes between taxpayers and tax administrations about the pricing of centralized procurement services may focus on differences of view about the appropriate method.

5.14.2.3 A CPM or TNMM on the basis of costs is likely to be an appropriate method where the procurement activities are mainly purchasing rather than sourcing, and any sourcing activity is limited in scope or relates to non-core spend, largely executes instructions from the recipient associated enterprises, and does not assume risks or perform risk control functions relating to the goods or services procured. In such a case the value to the MNE is mainly efficient deployment of resources, and a cost-based fee may appropriately measure that value. The arm's length mark-up may reliably be based on comparable independent service providers. As for many intragroup services that need to be benchmarked against independent service providers, identical activities may be hard to identify. Nevertheless, it is expected that independent service providers can be identified that provide broadly similar administrative services that would provide a sufficiently reliable range of mark-ups. These cost-based methods should not necessarily be rejected even if the activities are more extensive and require greater resources, greater expertise, and perhaps investment in tools and software. In such a case, the cost base for the centralized procurement company is likely to be greater, and a mark-up on that greater base will generate a higher fee.

5.14.2.4 However, where the procurement activities involve significant sourcing activities, relate to core goods and services, include business-critical decisions, and involve some risk assumption or performance of risk control functions, then the activities affect business outcomes and the value to the MNE may correlate to revenues or profits. The reliability of comparing the centralized procurement company to independent service providers under a CPM or a cost-based TNMM may be reduced. Instead, the application of arm's length commission rates under a CUP Method is likely to be appropriate.

5.14.2.5 In other situations, there may be differences between the uncontrolled and controlled procurement activities; for example, the items procured may relate to non-core spend rather than to core, business critical items; and the relationship between rates of commission and volumes may not be reliably ascertained. The reliability of the application of a CUP Method can be improved in these situations by bearing in mind the concept that at arm's length recipient parties will only be prepared to pay a fee if they expect to receive benefits from the outsourced procurement services provider that are greater than the fee. In practice, therefore, the information about commission rates resulting from a CUP Method can be interpreted and tested for reasonableness by an approach which seeks to identify the benefits derived from the procurement activities, and to share them between the centralized procurement company and the recipient associated enterprises based on their respective contributions, including any risk control functions.

5.14.2.6 The identification of benefits should not be speculative or created for the transfer pricing analysis but should be rooted in commercial measures that the MNE uses to assess performance (see the illustrations in section 5.7.5). If benefits are not measured by the MNE independently of a transfer pricing analysis, then this may suggest that the benefits are not commercially important and the activity is not one that makes a significant contribution to business performance (and consequently may suggest that a cost-based transfer pricing method is more appropriate). Care should be taken in such an analysis first to measure and deduct benefits arising from aggregation of volumes, which should be allocated to the associated enterprises contributing the buying power. The resulting share of benefits can corroborate commission-based fees and narrow the range of fees potentially identified through a CUP analysis. Evidence of gain-share agreements between independent parties can be difficult to use if it is not possible to determine reliably how the parameters for measuring the gain have been set in uncontrolled arrangements, and how those parameters might be adapted to apply to the controlled arrangement.

5.14.3 Application and Interpretation of Comparable Uncontrolled Price (CUP) Method with Example

5.14.3.1 The following is an example of how the results of a CUP Method can be interpreted, tested for reasonableness, and corroborated by an approach which shares benefits. Assume that a centralized procurement activity of Company A is responsible for sourcing and for managing the purchasing process for the core spend of a related manufacturing company, Company B. Company B purchases the goods directly from the suppliers sourced by Company A, and so any price discounts attributable to Company B's volume accrue directly to Company B. Both companies are part of the ABC Group. The spend managed by Company A represents 80 per cent of Company B's costs of goods. Company A incurs costs of 5 in performing its procurement activities. Company B sells its finished products to third parties; the products are technologically advanced, but the manufacturing process itself is not unique.

5.14.3.2 It is assumed that the comparability analysis has determined that Company A's activities contribute significantly to the business performance of Company B and involve Company A using its know-how to work closely with suppliers to improve specifications, monitor quality, evaluate alternative sources of supply, and ensure uninterrupted supply. Recently the ABC Group has made public commitments to recycle and re-use components, and Company A has led the initiative with suppliers to make the necessary changes and achieve the Group's targets. The management of ABC Group monitors closely the performance of Company A through key performance indicators of Company B's business and risks including inventory levels, production down-time through supply problems, product failures in quality checks, and recycling targets. Good performance by Company A can positively contribute to the revenues and costs, and therefore profits of Company B; poor performance risks adversely affect the profits of Company B.

5.14.3.3 It is further assumed that a CUP Method is appropriate. Potentially comparable commission rates in uncontrolled transactions are identified ranging between 1 per cent and 7 per cent of the managed spend. There are differences between the potential comparables and the activities of Company A, particularly because the comparables tend not to procure business-critical items nor assume responsibility for delivering key initiatives in the way that Company A does, and it is not possible reliably to determine how volume may affect the commission rates.

Assume that Company B's significant financials show the following:

Table 5.T.2
Application and Interpretation of the Comparable Uncontrolled Price (CUP) Method

Sales to third parties			1000	
Cost of Goods	(500)			Managed Spend by Company A is 400. Potential CUP range of 1 to 7 per cent equates to a procurement fee range of 4 to 28
Other Costs	(300)			
Total Costs		(800)		
Profits before procurement fee			200	
		Application of corroborating benefits share approach as described in the following paragraphs.		
		(80)		Benchmarked return to manufacturing (10 per cent of total costs)
			120	Residual profits attributable to Company B's technology and Company A's procurement activities
		(5.25)		Routine procurement fee to Company A (own costs of 5 plus a mark-up of 5 per cent)

Table 5.T.2 (continued)

Residual Profits			114.75	
Hypothetical technology royalty of 10 per cent			(100)	Company B has developed the technology embedded in the product. A relief from royalty valuation approach determines the hypothetical royalty payments that would be saved through owning the asset, as compared with licensing the asset from a third party.
			14.75	Profits earned by Company B relating to procurement activities of Company A

5.14.3.4 The profits before procurement fee of 200 are earned from Company B's manufacturing activities, to which Company A contributes through its procurement activities. However, Company B's manufacturing activities are enhanced by the investment that it has made in research and development resulting in the technological advances in the products. Company A has also made investments in intangibles, particularly in developing its know-how and proprietary systems. Assume that returns to routine manufacturing can be benchmarked at total costs plus 10 per cent. Applying that mark-up to total costs of Company B of 800 would give a profit of 80, leaving a residual of 120. Assume also that returns to routine procurement services can be benchmarked at cost plus 5 per cent, determining a routine fee to Company A on its costs of 5 of 5.25. The residual profit of 114.75 is attributable to a combination of Company B's technology and Company A's additional contribution to the business performance of Company B.

5.14.3.5 At this point it may be possible to share the residual profit of 114.75 in proportion to the investment of the two companies in intangibles if it is determined that the categories of investment by Company A and Company B are sufficiently similar in potential value to make such a sharing reliable. As an alternative, assume that the value of Company B's technology can reliably be estimated by determining the royalty payments that would be payable at arm's length if Company B did not own the technology but instead had to license it from a third party. Assume the valuation results in a royalty of 10 per cent. The resulting profits of 14.75 are therefore profits earned by Company B which relate to the additional contribution to its business performance from the procurement activities of Company A.

5.14.3.6 It may be possible to evaluate how the resulting profits of 14.75 should be shared between Company A and Company B by considering the metrics ABC Group uses to monitor Company A's performance. This would likely require converting to an impact on profits the stated performance measures relating to inventory levels, production down-time through supply problems, product failures in quality checks, and recycling targets. Conversion would likely require assumptions to be presented about base-line performance and placing a value in terms of profits on variations to the base-line. Such an analysis may be informative but may not be definitive.

5.14.3.7 Failing the above analysis, reasonable estimates need to be made in order to appropriately share the resulting residual profits of 14.75 between Company A and Company B. The analysis would immediately suggest that paying 28 to Company A (a commission of 7 per cent at the top of the CUP range on managed spend of 400) would attribute more than the residual profit amount to procurement activities (Company A is already attributed a routine return of 5.25, and so an additional 22.75 to arrive at a total fee of 28 would allocate nearly twice the residual to Company A). Instead, the analysis suggests that a commission rate nearer the lower end of the CUP range is more appropriate. If all the residual of 14.75 were allocated to Company A, then the maximum commission would be 5 per cent (calculated as the residual of 14.75 together with the routine return of 5.25 resulting in a procurement fee of 20, which is 5 per cent of managed spend of 400). Paying 8 to Company A (representing a commission of 2 per cent on the managed spend of 400) is towards the lower end of the CUP range, but would seem to represent a more reasonable share of residual profits between the two companies given the fact that it is Company B that assumes the majority of risks. Under the benefits share Company A has already been allocated 5.25 and the additional 2.75 represents approximately a 20/80 split of the residual profits of 14.75 in favour of Company B.

5.14.3.8 It should be noted that a fee of 8 in this example represents a mark-up of 60 per cent on Company A's own costs of 5. Such a mark-up is significantly in excess of, for example, the rate of return for Company B's manufacturing activities. Such a relatively high mark-up does not undermine the outcome of this example. The example is intended to be an illustration of the guidance in section 5.14.2.4 which states that "where the procurement activities involve significant sourcing activities, relate to core goods and services, include business-critical decisions, and involve some risk assumption or performance of risk control functions, then the activities affect business outcomes and the value to the MNE group may correlate to revenues or profits."

5.14.3.9 The reliability of comparing the centralized procurement company to independent service providers under a CPM or a cost-based TNMM may be reduced. Instead, the application of arm's length commission rates under a CUP Method is likely to be appropriate. The example shows how, in circumstances where a CUP Method is likely to be more reliable than a cost-based method, the potentially wide ranges of commission rates under a CUP Method can be narrowed, tested for reasonableness, and corroborated through the application of an approach which shares benefits.

5.14.3.10 In summary, replication of pricing structures used by independent outsourced procurement services providers is rarely an option that can be adopted in practice because of the difficulties in finding such data, in interpreting it reliably in the context of the controlled arrangement, and in estimating appropriate adjustments. The CPM or TNMM can be applied in most cases, even in cases where the centralized procurement company provides expert services and employs know-how and proprietary tools.

5.14.3.11 Where the activities contribute significantly to the commercial performance of the MNE and involve control of economically significant risks for the MNE, other methods may be appropriate. Commission rates in third-party arrangements may be available, with the result that a CUP Method can reliably be applied. Indicative commission rates under a CUP Method may be corroborated by an approach which shares accurately measured commercial benefits between the group procurement company and its associated enterprises. Reasonable estimates can be made under a benefit share approach to interpret and test the appropriate positioning in the range of commission rates indicated under the CUP Method.

5.14.3.12 This section sets out guiding principles when one method might be more appropriate than another in approximating the fee that the parties would have agreed had they been independent of each other. An understanding of the principles is necessary so that relevant distinctions of fact can be identified, and conclusions consistent with those distinctions reached. The application of those principles is important where there can be significantly different outcomes depending on the pricing method selected. The scope of significantly different outcomes is illustrated at 5.14.4; the example is a contrived one but the point is likely to be relevant for procurement activities when the amount of managed spend is so high relative to the cost of performing the activities that the gap in outcomes of the two approaches cannot reasonably be bridged through adopting, for example, high mark-ups under one method and low commission rates under another method. However, in practice, it may not always be the case that there is a significant gap, and there is usually little point in being dogmatic about the appropriate method if convergence of outcomes of each method is possible. Nevertheless, the example at 5.14.4 is also a reminder that while convergence might reasonably be achieved in Year 1, this would represent short-term pragmatism. The difference in outcomes does not remain static, and Year 2 and Year 3 indicate that a principled approach is required so that the relevant distinctions of fact can be made to determine which method is more appropriate in approximating the arm's length fee, as outlined in this guidance.

5.14.4 Extended Example

The following extended example is designed to illustrate application of the guidance in this section by demonstrating the role and expertise of the procurement service providers, the nature of the items procured and the associated commercial risks, the risks assumed or controlled by the group procurement companies, and the transfer pricing implications.

Assumed facts of the example

An MNE group involved in the manufacture of food products has centralized procurement activities in two companies, Company A, based in Europe, and Company B, based in Africa. The operations of the two companies are different, as described below, and lead to different conclusions about the application of reliable pricing methods.

Company A employs 50 staff and it operates to enhance standardization of products and services supplied to the group by independent vendors, and to provide better oversight and control of costs. Analysis shows that about 60 per cent of the spend it manages on behalf of the group involves non-core spend relating to procurement of packaging, logistics services, production machinery, information technology and communication equipment and services, and office equipment and supplies. In fulfilling its activities in relation to spend on non-core items it liaises with other group companies to understand their needs, sources and selects vendors, develops relationships with vendors, and negotiates terms. In practice packaging vendors regularly communicate directly with the group's Head of Development and also with production personnel located in the group's manufacturing plants to discuss innovations, cost reductions, and regulations. As a result, the role of Company A in relation to procurement of packaging is to place orders to already agreed specifications and with already selected and known vendors. The group recently experienced supply problems following a change in its supplier of logistics services following a tendering process organized by Company A. In accordance with the group's management controls, the decision to approve the new supplier was taken by the parent company with reference to analysis provided by Company A. The remaining 40 per cent of the spend it manages on behalf of the group relates to core spend on food ingredients. However, for these items Company A acts as a coordinator and aggregator of orders, as notified by other group companies, and performs the administrative functions of order processing and accounts payable. Company A assumes no risk in relation to the goods and services it procures and does not control significant risks. The performance of Company A is measured by its management on the basis of its order processing costs.

The MNE depends on the sustainability and quality of key ingredients and another MNE member company, Company B, provides procurement and sourcing functions for these core items. This company needs constant contact with sources of supply and is based in Africa. It has 20 employees. The employees develop relationships directly with growers and provide guidance on growing techniques to improve yields and quality. To increase the security of supply, Company B finds growers in new regions willing to use the technological know-how Company B provides. Company B works closely with production companies in the group to forecast demand as a result of changes in consumer preferences, and also with the group's development function in order that it can anticipate demand for sourcing of new ingredients. Company B's activities are critical to the group's performance and to control of economically significant risks. The performance of Company B is measured by its management with reference to uninterrupted supply for the MNE and mitigation of the effects of price volatility for the MNE. Company B reports regularly to the parent company about trends, sourcing opportunities and risks, and will seek approval for investment in new regions. Company B also fulfils the group's regulatory requirements in terms of traceability of the items it sources. Company B performs administrative functions of order processing and accounts payable, except for larger volume purchases, the details of which are referred to and processed by Company A.

Interpretation of the assumed facts for transfer pricing purposes

Company A performs a useful function for the group, but it would not seem to be a highly valuable one that contributes significantly to business performance. Company A performs an "execution-only" administrative function in relation to spend on business-critical core items, based on decisions made elsewhere in the group. In relation to spend on non-core items, these are not business-critical items, they are largely standardized and can be sourced from a range of readily identifiable suppliers competing on price. The fact that a new logistics services supplier caused supply problems for the group is not something that Company A is responsible for, assuming its organization of the tendering process was not negligent. Where deep knowledge of the products sourced is required, in the case of packaging, Company A has no role, except to process orders.

If Company A were compensated through a commission fee (by reference to a percentage of spend under management) based on the application of the CUP Method that resulted in profits many multiples of its own cost base, then in the absence of further evidence concerns would arise about why its activities justify such a valuation. There would also be concern in the absence of appropriate evidence if compensation for Company A included a share in savings made by the MNE based on its activities. The performance of Company A is not measured by management by reference to savings, the calculation of any savings would require a high standard of evidence, and Company A does not seem to have any specialized input or control any risks that would justify a sharing in any savings in the event that they could be reliably measured. The CPM or the TNMM based on costs seems more likely to be appropriate on the facts presented, subject to the reliability with which the methods can be applied in any given case.

Company B is a smaller operation than Company A in terms of headcount but it concentrates on business-critical aspects that can directly affect group profitability. Company B is deeply involved in developing sources of supply for core items and in working with its associated production companies in forecasting and meeting their demand. It helps to control economically significant risks for the group through influencing continuity of supply and resistance to price volatility, and the group measures its performance in managing these risks.

If Company B were compensated through a fee based on its costs plus a mark-up benchmarked by comparison with independent companies, there might be concerns about the reliability of the comparison, and particularly whether the potentially comparable independent companies take responsibility for the sourcing of core, business critical items for their clients. The outcome of a cost based method may understate the value created by Company B as measured by the MNE. On the facts presented, it is more likely that a method which takes into account the contribution to value by Company B would be appropriate. Commission rates in third-party arrangements may be available, with the result that the CUP Method can reliably be applied. Indicative commission rates under the CUP Method may be corroborated using an approach which shares benefits based on management's commercial measurements of savings.

Annex 1: Example List of Low Value-Adding Services

Example: List of Low Value-adding Services Developed by the EC

The following list of potential low value-adding intragroup services is based on Annex I of the European Commission's, Guidelines.[56] For further information on low value-adding services see section 5.5.2.

- Information technology services:
  - Building, development and management of the information system;
  - Study, development, installation and periodic/extraordinary maintenance of software;
  - Study, development, installation and periodic/extraordinary maintenance of hardware;
  - Supply and transmission of data; and
  - Back-up services.
- Human resource services:
  - Legislative, contractual, administrative, social security and fiscal activities connected to the ordinary and extraordinary management of personnel;
  - Selection and hiring of personnel;
  - Assistance in defining career paths;
  - Assistance in defining compensations and benefit schemes (including stock option plans);
  - Definition of personnel evaluation processes;
  - Training of personnel;
  - Supply of staff for limited period; and
  - Coordination of the sharing of personnel on a temporary or permanent basis; and management of redundancies.
- Marketing services:
  - Study, development and coordination of the marketing activities;
  - Study, development and coordination of the sale promotions;
  - Study, development and coordination of the advertising campaigns;

[56] EC (2011). Guidelines on low value adding intra-group services. Brussels: EC. Available from https://ec.europa.eu/taxation_customs/system/files/2016-09/c_2011_16_en.pdf.

    - Market research;
    - Development and management of Internet websites; and
    - Publication of magazines handed out to clients of the subsidiary (even if concerning the whole group).

- Legal services:
    - Assistance in the drafting and reviewing of contracts and agreements;
    - Ongoing legal consultation;
    - Drafting and commissioning legal and tax opinions;
    - Assistance in the fulfilment of legislative obligations;
    - Assistance in the judicial litigation;
    - Centralized management of relationship with insurance companies and brokers;
    - Tax advice;
    - Transfer pricing studies; and
    - Protection of intangible property.

- Accounting and administration services:
    - Assistance in the preparation of the budget and operating plans; keeping of the mandatory books and accounts;
    - Assistance in the preparation of periodical financial statements, annual and extraordinary balance sheets or statements of account (different from the consolidated financial statement);
    - Assistance in compliance with fiscal obligations, such as filing tax returns, computing, and paying taxes etc.; data processing; and
    - Audit of the account of the subsidiary; and management of the invoicing process.

- Technical services, for example:
    - Assistance regarding plant, machinery, equipment, processes etc.;
    - Planning and executing ordinary and extraordinary maintenance activities on premises and plant;
    - Planning and executing ordinary and extraordinary restructuring activities on premises and plant;

  - Transfer of technical know-how;
  - Providing guidelines for the products' innovation;
  - Production planning to minimize excess capacity and meet demand efficiently;
  - Assistance in planning and implementing capital expenditure;
  - Efficiency monitoring; and
  - Engineering services.

- Quality control services:
  - Providing quality policies and standards of the production and provision of services;
  - Assistance in obtaining quality certifications; and
  - Development and implementation of client satisfaction programmes.

- Other services:
  - Strategy and business development services in case there is a connection with an existing (or to be established) subsidiary;
  - Corporate security;
  - Research and development;
  - Real estate and facility management;
  - Logistic services;
  - Inventory management;
  - Advice on transport and distribution strategy;
  - Warehousing services;
  - Purchasing services and sourcing raw materials;
  - Cost reduction management; and
  - Packaging services.

6 Transfer Pricing Considerations for Intangibles

6.1 Introduction

6.1.1 Intangibles affect nearly every aspect of economic activity in the twenty-first century. Intangibles have become a major source of sustainable competitive advantage for many firms. The importance of intangibles in the economy has been growing for decades in a number of sectors. The information and communication technology (ICT) revolution has made some technologies cheaper and more powerful, enabling improvement of business processes and boosting innovation across virtually all sectors of the economy. This technological evolution has made intangibles increasingly important profit drivers in many individual businesses. It is therefore necessary to give careful consideration to intangibles when conducting a transfer pricing analysis.

6.1.2 Transfer pricing issues can arise in a number of different ways when MNEs develop, acquire, exploit or transfer intangibles. Various entities within an MNE may participate in the development of intangibles through functions like research, development and marketing, providing funding for acquisition and development of intangibles. When one member of the MNE performs functions which contribute to the development of or enhance the value of intangibles belonging to another MNE member, it should be compensated on an arm's length basis for those functions.

6.1.3 Various entities in an MNE group may exploit intangibles in a wide range of business activities. The rights to the intangibles thus exploited may belong to the entity exploiting the intangible or may have been made available to it by other members of the MNE. When one entity in the group makes an intangible available to another member of the MNE by transfer, license or otherwise, the entity making the intangible available to another MNE member should be compensated on an arm's length basis for making the intangible available.

6.1.4 The value of products or services sold or otherwise made available by one member of an MNE to another member of the MNE may be enhanced by intangibles owned or utilized by the entity providing the product or service. In this situation the party providing the product or service should be compensated for the value of the product or service on an arm's length basis, including being compensated for the value attributable to the intangibles utilized in providing the product or service.

6.1.5 Transfer pricing issues relating to intangibles should be resolved using the fundamental transfer pricing principles contained in Chapters 2, 3 and 4 of this Manual. However intangibles may be unique, may be difficult to value and may be critical to the successful operation of the MNE's business. Transfer pricing issues related to intangibles can therefore be very challenging for both tax administrations and taxpayers in developed and developing countries. This Chapter supplements the general principles contained in earlier Chapters to provide special practical guidance on transfer pricing matters related to intangibles.

6.1.6 In carrying out a transfer pricing analysis involving intangibles it is necessary to consider: (i) the identification of the specific intangibles involved, (ii) the ownership of intangibles within the MNE, (iii) the value of the identified intangibles, (iv) how the intangibles contribute to the creation of value by the MNE, and (v) the identity of the members of the MNE that contribute to intangible value and how they should be rewarded. This framework for analyzing transfer pricing issues related to intangibles is discussed in the following sections.

6.2 Identifying Intangibles

6.2.1 Definition of Intangibles

6.2.1.1 Article 9 of the UN Model Tax Convention is concerned with the conditions of transactions between associated enterprises, not with assigning labels to such transactions. The key consideration is whether a transaction conveys economic value from one associated enterprise to another, and whether that benefit derives from tangible property, intangibles, services or other activities. As is the case with other transfer pricing matters, the analysis of cases involving the use or transfer of intangibles should begin with a thorough identification of the commercial and financial relations entered into by the associated enterprises and the economically relevant characteristics attached to those relations. Such an approach is pursued in order to accurately delineate the actual transaction involving the use or transfer of intangibles. However, whether a particular item falls within the definition of intangibles or not will have little consequence for the analysis, since the principles in Chapters 2, 3 and 4 will apply in any event. The following definition is provided primarily to aid in discussion rather than to create a substantive difference between cases involving intangibles and those that do not.

6.2.1.2 Difficulties can arise in a transfer pricing analysis from definitions of the term "intangible" that are either too narrow or too broad. Where an overly narrow definition of the term "intangible" is applied, either taxpayers or governments may argue, incorrectly, that certain items fall outside the definition. The contention would be that such assets may therefore be transferred or used without separate compensation, even though such use or transfer would give rise to compensation in transactions between independent enterprises. If too broad a definition is applied, either taxpayers or governments may argue, again incorrectly, that the use or transfer of an item in transactions between associated enterprises should require compensation in circumstances where no such compensation would be provided in transactions between independent enterprises.

6.2.1.3 For the purposes of this Chapter the term "intangible" encompasses something which is neither a physical nor a financial asset, which is capable of being owned or controlled for commercial purposes, whose use or transfer would be compensated had it occurred between independent enterprises in comparable circumstances.[57] Whether something is recognized as an intangible for legal or accounting purposes is an informative starting point but not determinative. It is not the case that all valuable intangibles are legally protected, registered or recognized for accounting purposes.

6.2.1.4 It is recognized that some countries use a different definition in their domestic law. However, irrespective of whether an item is characterized as an intangible under domestic law, the transfer pricing analysis will be based on the definition above. Of course, other elements may need to be taken into account if they would affect pricing between unrelated parties. See for example the items discussed in section 6.2.5 below.

6.2.2 Classification of Intangibles

6.2.2.1 Notwithstanding the above, labels, such as those described in section 6.2.2.3, are applied to certain intangibles in some countries; this treatment often applies to intangibles with legal status. While such categorization may be helpful in identifying intangibles as a starting point of the analysis, the approach contained in this Chapter for determining arm's length prices in

[57] This definition is the same as the one in the G20/OECD Reports on BEPS Actions 8 to 10 released in October 2015, and now incorporated into the OECD Transfer Pricing Guidelines. See para. 6.6.

cases involving intangibles does not rely on any categorization. As a result, no attempt is made to delineate with precision various classes or categories of intangibles or to prescribe outcomes that turn on such categories. The categories of intangibles described below are ones often considered in transfer pricing analyses involving intangibles. They are illustrative and not intended to be comprehensive.

6.2.2.2 From a transfer pricing standpoint, it should be emphasized that generic references to the categorization as outlined below do not relieve either taxpayers or tax administrations from carrying out a thorough transfer pricing analysis. The analysis should identify intangibles as accurately as possible, taking into account the risks actually assumed and controlled, associated with the functions performed and assets employed. Similarly, the arm's length principle applies in the same way, irrespective of the type of intangibles at stake.

6.2.2.3 A common distinction is made between legally registered and unregistered intangibles. One category of intangibles includes intellectual property such as patents and trademarks, which can be registered. Other types of intangibles, such as copyrights or legal rights (including licenses) covering the utilization of patents, literary works, databases, trade secrets or designs can be legally or contractually protected even if not registered. These types of intangibles can be expressly registered, contractually acknowledged or legally protected, depending on the applicable national laws and treaties.

6.2.2.4 As indicated above, it is not the case that all valuable intangibles are legally protected and/or registered. Know-how and trade secrets are proprietary information or knowledge that assist or improve a commercial activity, but that an enterprise may — for a variety of business reasons — choose not to register. Such know-how may nonetheless contribute substantially to the success of the enterprise and be of significance in some situations for transfer pricing purposes.

6.2.2.5 Notwithstanding the fact that the availability and extent of contractual forms of protection may affect the value of an asset such as an intangible (and the returns attributable to it), the existence of any such contractual protection is not a necessary condition for an item to be characterized as an intangible for transfer pricing purposes.

6.2.2.6 Conceptually, intangibles can cover a wide spectrum encompassing legally defined items such as patents and trademarks up to broader categories such as best practices, internal procedures, human capital, non-contractual relations to customers or suppliers and network effects. The latter categories of items are not necessarily legally defined but may, taking into account particular facts and circumstances, convey value that would be compensated between parties at arm's length, and, as such, should be considered as a relevant economic characteristic in any comparability analysis involving the use or transfer of intangibles.

6.2.2.7 In considering transfer pricing matters certain intangibles may sometimes be referred to as either (i) trade intangibles or (ii) marketing intangibles.

6.2.3 Trade Intangibles

6.2.3.1 Trade intangibles may be created through testing and research and development (R&D) activities. The developer may try to recover the expenditures on these activities and obtain a return thereon through manufacturing and selling products, service contracts, or licensing out.

6.2.4 Marketing Intangibles

6.2.4.1 Marketing intangibles may be created by marketing activities, can aid in the commercial exploitation of a product or service, and/or may have an important promotional value for the product concerned. Depending on the facts and circumstances of the case, marketing intangibles may include, e.g. trademarks, trade names, customer lists and customer relationships as well as proprietary market and customer data that is deployed in marketing activities and in selling goods or services to customers.

6.2.4.2 There can be a combination of central and local marketing activities carried out in MNEs. In some cases the local marketing team performs marketing activities which are comparable to the activities of comparable uncontrolled distributors. In other cases, the local marketing team carries out broader marketing activities than the ones of uncontrolled distributors, e.g. it may autonomously develop marketing campaigns or customize the commercial offering beyond the guidelines set centrally and, accordingly, the local marketing team may incur significantly greater expenses than comparable uncontrolled distributors. In the latter case, the local marketing team may succeed in developing a marketing intangible.

6.2.4.3 A separate concept is whether a particular intangible will be regarded as "unique and valuable". For transfer pricing purposes, a "unique and valuable intangible" is an intangible which is not present in otherwise comparable uncontrolled transactions (unique); and leads to significant expected premium value in business operations (valuable).

6.2.4.4 When looking at local marketing activities undertaken by a distributor, it should be determined:

- ➢ Whether or not the marketing activities of Distributor X create a separate intangible distinct from the foreign-owned brand, and
- ➢ Irrespective of the answer to the first question, whether or not the marketing activities of Distributor X that are in excess of those of comparable uncontrolled distributors should attract a return greater than those comparables. See section 6.2.4.2 above.

6.2.4.5 Depending on the facts and circumstances of the case, the broader marketing activities of the distributor may give rise to differing outcomes:

a) The activities may lead to the creation of a local marketing intangible but not attract a return greater than the return of otherwise comparable uncontrolled distributors, for instance if the resulting intangible is not unique, despite the expenses incurred being greater than those of comparable uncontrolled distributors;

b) The activities may lead to the creation of a local marketing intangible (distinct from the foreign-owned brand) and attract a return greater than that of otherwise comparable uncontrolled distributors, for instance if the resulting intangible is unique and valuable;

c) The activities may not lead to the creation of a local marketing intangible and not attract a return greater than the return of otherwise comparable uncontrolled distributors, for instance if the additional value created is captured by the distributor through anticipated increased sales volumes; or

d) The activities may not lead to the creation of a local marketing intangible but attract a return greater than the return of otherwise comparable uncontrolled distributors, for instance if the distributor's marketing activities are a valuable contribution to the foreign-owned brand.

6.2.4.6 Example 1: Distributor X distributes branded products. The relevant brand is owned by a foreign affiliated enterprise. Assume that Distributor X has an innovative marketing team whose activities go beyond the implementation of the guidelines set by the brand owner. Distributor X successfully develops customized campaigns for the local market in which Distributor X operates. As a consequence, Distributor X is very successful in its market and its marketing expenses are significantly greater than the marketing expenses of otherwise comparable uncontrolled distributors. Assume that the incremental marketing expenses are not reimbursed by the foreign brand owner. In this case, the determination will likely be either outcome (b) or (d) of the list at 6.2.4.5 above, i.e. Distributor X would attract a return greater than the return of otherwise comparable uncontrolled distributors.

6.2.4.7 Example 2: Distributor Y distributes branded products. The relevant brand is owned by a foreign affiliated enterprise. Assume that the foreign brand owner runs a comprehensive global marketing team and that Distributor Y solely implements locally the marketing campaigns which are designed by the foreign brand owner. Furthermore, the foreign brand owner reimburses Distributor Y for incremental marketing expenses (if any) incurred above the expenses of comparable uncontrolled distributors. In this case the determination will likely be either be outcome (a) or (c) of the list at section 6.2.4.5, i.e. Distributor Y would not attract a return greater than the return of otherwise comparable uncontrolled distributors.

6.2.5 Other Aspects of Identifying Intangibles

Market Features

6.2.5.1 The specific characteristics of a given market may affect the arm's length conditions of a transaction between associated enterprises in that specific market. In conducting a transfer pricing analysis taking into account the specific market features in which one or more of the associated enterprises is operating, one should distinguish between the local market characteristics, which are not intangibles, and other features — such as contractual rights granting exclusivity in marketing certain products or government licenses — which meet the definition of intangibles relevant for transfer pricing purposes. While some of the economic circumstances existing in a market (e.g. cost of labour) may give rise to location savings, others may trigger the need to focus on comparability issues not directly associated with location savings. See 3.4.5.15 to 3.4.5.17.

Goodwill

6.2.5.2 The manner in which an intangible comes into existence from an accounting standpoint is not relevant to the determination of whether the item is an intangible for transfer pricing purposes. In this respect, goodwill is often a significant issue in discussions of the transfer pricing aspects of intangibles in the course of a business restructuring relates.

6.2.5.3 Depending on the context, the terms "goodwill" and "ongoing concern value" can be used to refer to a number of different concepts:

- In some accounting and business valuation contexts, goodwill reflects the difference between the aggregate value of an operating business and the sum of the values of all separately identifiable tangible and intangible assets (see example in section 6.2.5.11 below);
- Alternatively, goodwill is sometimes described as a representation of the future economic benefits associated with business assets that are not individually identified and separately recognized;
- In still other contexts goodwill is referred to as the expectation of future trade from existing customers;
- The term ongoing concern value is sometimes referred to as the additional value that attaches to property by reason of its existence as an integral part of an ongoing business activity;
- It is also sometimes described as the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning, or generating income without interruption, notwithstanding a change in ownership, aside from any intangibles; and
- It is also sometimes referred to as the value of the assembled assets of an operating business over and above the sum of the separate values of the individual assets.

6.2.5.4 It is generally recognized that goodwill and ongoing concern value cannot be segregated or transferred separately from other business assets.

6.2.5.5 It is not necessary for purposes of this Chapter to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes or to define when goodwill or ongoing concern value may or may not constitute an intangible. It is important to recognize, however, that an important and monetarily significant part of the compensation paid between independent enterprises when some or all of the assets of an operating business are transferred may represent compensation for something referred to by one or another of the alternative descriptions of goodwill or ongoing concern value.

6.2.5.6 When similar transactions occur between associated enterprises, such value should be taken into account in determining an arm's length price for the transactions. The absence of a single precise definition of goodwill makes it essential for taxpayers and tax administrations to describe specifically relevant intangibles in connection with a transfer pricing analysis, and to consider whether independent enterprises would provide compensation for such intangibles in comparable circumstances.

6.2.5.7 When the reputational value, sometimes referred to as goodwill, is transferred to or shared with an associated enterprise in connection with a transfer or licence of a trademark or other intangible, that reputational value should be taken into account in determining appropriate compensation.

6.2.5.8 If features of a business such as a reputation for producing high quality products or providing high quality services allow that business to charge higher prices for goods or services than an entity lacking such reputation, and such features might be characterized as goodwill or ongoing concern under one or another definition of such terms, such features should be taken into account in establishing arm's length prices for sales of goods or the provision of services between associated enterprises whether or not they are characterized as goodwill. In other words, all contributions of value should be compensated at arm's length irrespective of how they are labelled.

Purchase Price Allocation

6.2.5.9 When a multinational enterprise acquires a company, group of companies or business it may prepare a Purchase Price Allocation for financial accounting purposes (commonly referred to as a "PPA"). Such PPA typically provides a financial valuation of identified underlying tangible and intangible assets. In the event where one or more of the intangibles are further transferred after the acquisition, for instance as part of a business restructuring, the question arises as to the extent to which the PPA will provide a useful basis for valuation of the further transferred intangible(s).

6.2.5.10 Goodwill under a PPA for financial accounting purposes is mechanically defined as the difference between the purchase price (typically of a company or a business) and the valuation of identified underlying tangible and intangible assets. While the PPA can be a useful starting point to identify intangibles and their value, it is worth noting that any mis-valuation of any of the identified underlying tangible and intangible assets (due, for example, to unaccounted synergies, other unaccounted sources of value or measurement errors) mechanically affects goodwill valuation as illustrated below.

6.2.5.11 **Example: Illustration of Purchase Price Allocation**

Assume Company A is acquired by Company B for a price of 1,000. In its PPA for consolidated financial accounts' purposes, Company B allocates to underlying tangible and intangible assets the purchase price it paid for Company A. In doing this, valuations are made for identified assets of Company A. Goodwill will be recognized for the residual value as follows:

Tangible assets:	100
Sum of Patents 1, 2 and 3 (valued separately):	150
Trademark:	250
Unallocated "goodwill"	500
Total purchase price allocated:	1 000

Assume that in the post-acquisition context the patents will be exploited as a bundle in order to derive synergetic benefits. Assume that while the sum of the individual values of Patents 1, 2 and 3 is 150, their value, if sold as a bundle, would be 250, because of incremental value that can be derived from the interrelated use of the patents.

In such a case, if the transaction analyzed is the sale of Patents 1, 2 and 3 as a bundle, part of the PPA measure of goodwill value should be allocated to the value of the bundle. The result would be the following:

Tangible assets:	100
Patents 1, 2 and 3 (valued as a bundle):	250
Trademark:	250
Unallocated "goodwill"	400
Total purchase price allocated:	1 000

6.2.5.12 **Example: MineCo Transfer of Goodwill with Drilling Licenses**

Assume MineCo owns a government license to carry out oil drilling activity in Ruritania as well as another government license for the exploitation of the oil rig network existing within the country. The oil drilling license has a stand-alone market value of 70. and the oil rig license has a stand-alone market value of 30. MineCo does not own any other assets.

ExtraCo, an independent competitor of MineCo, acquires 100 per cent of the equity interest in the latter company for a price of 150. In its PPA prepared in connection with the acquisition, ExtraCo attributes 70 to the license associated with the drilling activity, 30 to the oil rig license and the remaining amount of 50 to goodwill arising because of the existence of synergies created between the drilling and oil rig licenses taken together.

As an immediate follow-up of the acquisition, MineCo transfers both the above licenses to Extra1, a subsidiary of ExtraCo. In carrying out a transfer pricing analysis related to determining the arm's length consideration to be paid by Extra1 with respect to the transaction taking place with MineCo, the taxpayer values the combined transaction at 100, the sum of the market values of the two licenses considered separately.

In this case, in calculating the arm's length consideration the purported goodwill associated with the bundled transfer of licenses by MineCo should be taken into account, as a party at arm's length would be willing to pay more than 100 for combined assets that have a value of 150.

Group Synergies

6.2.5.13 Because of the existence of an MNE, the associated enterprises comprising such MNEs may benefit from interactions or synergies among MNE members which are not generally available to independent enterprises. Examples include streamlined management, elimination of costly duplication of effort, economies of scale, integrated systems, purchasing or borrowing power. This type of synergy does not constitute an intangible because it is not capable of being owned or controlled by an enterprise in accordance with the definition in 6.2.1.3. However, group synergies can have an effect on the determination of arm's length prices and other conditions for controlled transactions. Section 2.5.5 provides guidance on the transfer pricing treatment of group synergies.

Workforce in Place

6.2.5.14 Another important aspect to be taken into account in a transfer pricing analysis can be the existence of a qualified and skilled workforce.

6.2.5.15 Generally, the existence of the workforce does not need to be remunerated separately for transfer pricing purposes. This is because the value provided by a workforce is typically reflected in the arm's length consideration to be paid for the goods produced or the services performed by the workforce. By contrast, rights under contracts — which may include the use of a workforce in place — could constitute an intangible within the meaning of section 6.2.1.3.

6.2.5.16 Another situation concerns the transfer of an assembled workforce, e.g. in the context of a business restructuring. Such a transfer may be justified for a variety of reasons, such as the possibility for the transferee of not hiring and training a new workforce. On the other hand, the transfer of an assembled workforce may trigger some liabilities in the hands of the transferee in the event some contracts have to be terminated as part of the implementation of the business restructuring plan. In such a case, the most appropriate transfer pricing method to be selected as well as the calculation of any potential indemnity has to take such elements into account.

6.2.5.17 From a transfer pricing standpoint, it is important to distinguish between the transfer of an assembled workforce in the context of a business restructuring and the mere secondment of employees, which is common in any MNE. As a general rule, it is very rare that a transfer of individual employees between members of an MNE should be compensated beyond the mere reimbursement of the employment and other associated costs, or the remuneration required for the services carried out by the seconded employees.

6.2.5.18 The use or transfer of part or all of a workforce does not, in itself, constitute the transfer of intangibles. However, it can also be the case that the transfer of certain employees is accompanied by the transfer of intangibles such as know-how from one associated enterprise to another.

6.2.5.19 **Example: Pricing Algorithm**

> Assume that several employees of Company G have developed over the years a specific algorithm to accurately price derivative instruments. The algorithm is owned by Company G since it was developed by the individuals in their capacity as employees of Company G. Assume that the employees are seconded by Company G to the associated Company M. The secondment of the personnel from Company G to Company M does not constitute a transfer of an intangible.
>
> Assume now that, as part of their secondment, the seconded employees, with the authorization of Company G, make the algorithm available to Company M to assist and use in its commercial operations. This may result in an intangible, i.e. the algorithm, being put at the disposal of Company M by Company G, for which arm's length consideration may need to be paid by Company M to Company G.

6.3 Ownership of Intangibles and Transactions Involving Intangibles

6.3.1 Analytical Framework for the Use or Transfer of Intangibles

6.3.1.1 Applying the arm's length principle to transactions involving the use or transfer of intangibles is not fundamentally different from applying it to transactions involving tangible assets or services. Indeed, the arm's length principle requires in both instances the performance of a thorough comparability analysis, with a specific focus on the identification of the entities performing functions, employing or contributing assets (including funding), and assuming risks.

6.3.1.2 On the basis of the above, the guidance on the transfer pricing aspects of intangibles should be placed within the wider context of understanding the accurately delineated transaction including identifying, within the value chain, how associated enterprises make contributions in the form of functions performed, assets employed and risks assumed.

6.3.1.3 The framework for analyzing transactions involving the use or transfer of intangibles between associated enterprises requires undertaking the following steps:

6.3.1.4 Fact finding relating to the intangible:

- ➢ Identify the specific intangibles involved in the transaction between associated enterprises (see section 6.2 above);
- ➢ Identify the legal ownership of intangibles based on registrations, contracts and other relevant documents; (see section 6.3.2 below); and
- ➢ Identify specific contributions made with respect to DAEMPE (development or acquisition, enhancement, maintenance, protection and exploitation) of the intangibles involved (see sections 6.3.3 and 6.3.4 below).

6.3.1.5 Fact finding relating to a transaction involving the *use or transfer* of intangibles:

- ➢ Identify other contractual terms associated with the transactions (if any), including terms of payment and terms of use of the intangible being transferred or used; and
- ➢ Identify the associated enterprises performing functions, using assets and contractually assuming risks in the transactions involving intangibles. The guidance in Chapters 3 and 4 should be applied.

6.3.1.6 Assess consistency with the arm's length principle of the remuneration of the transaction involving the use or transfer of intangibles between associated enterprises:

- ➢ Assess the consistency between the terms of the relevant contractual arrangements and the actual conduct of the parties: i.e. determine whether the conduct of the parties is aligned with the contractual assumption of the economically significant risks in relation to the intangible, including whether they actually control and have the financial capacity to assume the risks; See 3.4.3;

- Based on the above, delineate the actual transaction between the associated enterprises involving the use or transfer of intangibles; and
- Determine arm's length prices for the above-mentioned transactions consistent with each respective party's contribution to the economic value generated from the intangible (unless in the exceptional circumstances described in Chapter 3, section 3.3.2.2 apply, such as, where the arrangements viewed in their totality are not commercially rational).

6.3.1.7 It is important to note that in the vast majority of cases involving an intragroup transfer of intangibles, an arm's length result will be achieved by pricing the accurately delineated transaction.

6.3.1.8 However, in some exceptional circumstances, the tax authorities may potentially recharacterize the transaction according to its actual economic features. For a more detailed discussion on this issue, see section 3.3.2.

6.3.1.9 From a tax administration's standpoint there are clearly risks in recharacterizing transactions in the context of intangibles. This solution indeed may create an increased risk of double taxation, with no realistic prospect of cross-border relief in the event countries do not agree on a common set of principles. This could make the costs of doing business in the country sufficiently high to discourage cross-border trade and investment, with negative effects on development. As already stated in other parts of this Manual, while it is for each country to determine its own tax system, the desire to avoid double taxation has been an important factor in the very broad acceptance of the arm's length principle internationally.

6.3.2 Legal Ownership and Contractual Terms

6.3.2.1 Legal rights associated with an intangible provide a starting point for the analysis. These may be found in registrations, contracts or other communications between the parties, which may establish the legal owner of the intangible and describe the roles, responsibilities, and rights associated with parties to the transaction involving the intangible. Contractual payment terms (for example, licensing terms) may establish how receipts and expenses of the MNE are allocated, and the form and amount of payments. These contractual terms may indicate, for example, the party or parties entitled to unanticipated gains or losses from the exploitation of the intangible.

6.3.2.2 In the case of a licensed intangible there are two different intangibles, each having a different owner: the licensed intangible on the one hand, and the license rights held by the licensee on the other hand. The fact that an intangible is being licensed does not affect its legal ownership, but rather creates a separate right of use for the licensee.

6.3.2.3 The legal owner(s) will be considered to be the sole owner(s) of the intangible for transfer pricing purposes. If no legal owner is identified, then the member of the group that controls decisions concerning exploitation of the intangible and that has the practical capacity to restrict others will be considered the legal owner.

6.3.2.4 Legal ownership, by itself, does not confer any right ultimately to retain returns associated with intangibles, even though such returns may initially accrue to the legal owner according to the contractual terms. In other words, it is not the case that the legal owner of an intangible, purely by virtue of its ownership, is entitled to the returns associated with the intangible. In effect, it would not be consistent with the arm's length principle for the fruits of intangibles to be stripped away from entities which have developed or significantly contributed to the development of those intangibles by a mere paper transaction assigning legal ownership elsewhere. Instead, all contributions must be appropriately remunerated rather than exclusively remunerating only the legal owner.

6.3.2.5 Several types of returns are associated with an intangible, including for example: an appropriate return to development functions, an appropriate return to funding activities, an appropriate return to exploitation functions and an appropriate return to the assumption of risk (this last return can be positive or negative, depending on whether and to what extent risks materialize).

6.3.2.6 For instance, assume that the legal owner of an intangible did not fund its acquisition (whether from a third party or from an associated enterprise) or development. Assume further that it does not assume any risk with respect to that intangible. In addition, assume that it does not perform any function other than the legal protection of the asset and in particular it does not perform any function in relation to the enhancement, maintenance, and direct or indirect exploitation of the intangible. In such a case the legal owner should not be entitled to share in any portion of the anticipated (ex ante) return associated with the development or acquisition, enhancement, maintenance or commercial exploitation of the intangible, beyond the appropriate remuneration for its legal protection function. This is illustrated by the example below.

6.3.2.7 RCo — R&D funding - Assume RCo is a member of an MNE group engaged in R&D activities, manufacturing and distribution of high-tech widgets. RCo funds its R&D activities. When RCo's R&D activities result in patentable inventions, all the rights in the patents are assigned to an affiliated enterprise LCo for no remuneration, which de facto acts as the intellectual property (IP) company of the group. LCo then grants to RCo a licence for RCo to use the patents in manufacturing and distribution activities. LCo does not perform any function in relation to the enhancement and maintenance or exploitation of the patents. LCo only employs two lawyers to perform the patent administration work required to register the intangibles generated by the ongoing R&D functions performed by RCo.

6.3.2.8 In this example an accurate delineation of the transaction would show that RCo performs all the relevant value-adding activities associated with the intangible and assumes all the significant risks. In particular, depending on the facts and circumstances of the case, one possible solution could be that the transfer of the legal ownership of the patents to LCo, taken together with the simultaneous license arrangement with RCo, reflects, in its true underlying economic determination, a patent administration service arrangement between RCo and LCo. As a result, RCo should be entitled to the actual return associated with the commercial exploitation of the asset, minus an arm's length remuneration for the legal protection functions performed by LCo.

6.3.3 The Significance of DAEMPE

6.3.3.1 DAEMPE stands for Development, Acquisition, Enhancement, Maintenance, Protection and Exploitation of intangibles.

6.3.3.2 While the analysis of intangibles generally follows the same analytical path as for other types of transactions there are a number of aspects of intangibles that typically warrant scrutiny within the fact-finding phase. These relate to:

- The ***d***evelopment of or, alternatively, the ***a***cquisition from third parties of intangibles (i.e. how the intangible came to be owned by the MNE group);

- The ***e***nhancement of intangibles;
- The ***m***aintenance of intangibles;
- The ***p***rotection of intangibles; and
- The ***e***xploitation of intangibles (whether direct exploitation or indirect exploitation such as licensing out).

6.3.3.3 These areas for analysis are sometimes referred to as "DAEMPE" contributions. In order to evaluate transactions involving intangibles, it is important to understand all of these contributions, as some or all of them might reflect important contributions to value that must be appropriately remunerated. While DAEMPE activities might seem to be limited to functions, in fact they often reflect contributions of assets and the assumption of risks as well. For example, a pharmaceutical company might commit to undertaking R&D in order to develop a potential blockbuster drug. This "D" reflects, in addition to the development functions (R&D), a commitment to contribute assets to fund the development and the assumption of potentially significant risks.

6.3.3.4 It is appropriate to make a technical note on the terms "DAEMPE" and "DEMPE". By referring to "DAEMPE" in the UN Manual there is no intention to diverge from the G20/OECD guidance contained in the Final Report on BEPS Actions 8-10, but rather to clarify that intangibles can be acquired by an MNE group either through development activities or by an acquisition from a third party. See for instance paragraph 6.49 of the OECD Transfer Pricing Guidelines.

6.3.4 Functions, Assets and Risks Contributing to DAEMPE

6.3.4.1 As discussed in section 6.3.3.2, accurately delineating the transaction between associated enterprises involving the use or transfer of intangibles requires identifying which associated enterprises contribute to DAEMPE. Such a process evaluates which entities perform functions, contribute assets and assume risks in the transactions involving intangibles.

6.3.4.2 The identification of important DAEMPE contributions may have a significant impact on the selection of the most appropriate transfer pricing method. The relative importance of contributions with respect to DAEMPE will vary depending on the industry, the type of intangible, the stage in the life cycle of the intangible, and the multinational enterprise's value chain in relation to that intangible. Important functions can be either directly performed or outsourced by the legal owner of the intangible.

6.3.4.3 For example, a fully developed and currently exploitable intangible purchased from a third party may require no development, maintenance or enhancement. In this case, key functions in relation to the acquisition of the intangible are those necessary to select the most appropriate intangible in the market, to analyze its anticipated benefits, take the decision to take on the risk-bearing opportunity through purchasing the intangible and manage the actual conclusion of the acquisition. A key asset would be the funding required to purchase the intangible.

6.3.4.4 For self-developed intangibles important functions in relation to the development of the intangible are those necessary to select the most appropriate research and development project, to analyze its anticipated benefits, and take the decision to take on the risk-bearing opportunity through funding the development activities and the performance of the R&D function. A key asset would be the funding required to develop the intangible.

6.3.4.5 In respect of both acquired and internally developed intangibles, the type of return warranted by the provision of funding will depend on the extent of the functions performed and risk assumed by the funding entity. See sections 6.3.5 and following for more details.

6.3.4.6 In some cases an acquired intangible may require some further development before it becomes fully exploitable. In such cases, a combination of contributions related to the acquisition and the development of the intangible will be needed.

6.3.4.7 Example: MMD Co.

Assume that MMD Co. is a company engaged in the sports apparel industry in Country Y. It owns a trademark "MMD" for which it designs and funds global marketing campaigns. The trademark MMD is well known in the market and attracts a premium return compared to its competitors. MMD Co. performs R&D activities and designs and manufactures athletic footwear under the trademark "MMD". The footwear manufactured by MMD Co. is sold in various markets through a network of third-party retailers. MMD Co. has an affiliated invoicing entity, SCo. Assume that SCo does not make any contribution to DAEMPE in relation to the MMD brand and to the shoe design. SCo solely performs invoicing activities. On the basis of the fact pattern described above a correct transfer pricing analysis should imply that SCo has no claim in relation to the return derived from the exploitation of the intangibles associated with the trademark "MMD", beyond an appropriate remuneration for its invoicing activities.

6.3.5 Risks

6.3.5.1 A comparability (including functional) analysis would be incomplete unless the economically significant risks assumed by each party to the controlled transaction have been identified to delineate the actual transaction involving the use or transfer of intangibles.

6.3.5.2 The guidance in Chapter 3, in particular the discussion of risk control and mitigation and of financial capacity to assume risk, applies to the analysis of intangibles. Risks that may be especially relevant relating to transactions involving intangibles include:

- Risks related to the development of the intangible: in order to decide whether or not to take on this risk, an evaluation needs to be performed of whether the intangible potentially relates to commercially viable products, what are the expected costs of the required development, and the possibility that such development will be unsuccessful;
- Risks related to technology obsolescence and loss of intangible value: in order to decide whether or not to take on this risk, an evaluation needs to be performed of the likelihood that competitors will introduce products or services that would materially erode the market for products dependent on the intangibles being analyzed;
- Risks related to the infringement of intangible rights: in order to decide whether or not to take on this risk an evaluation needs to be performed of the likelihood that third parties may successfully infringe the rights related to the intangible being developed, and the likelihood that third parties may successfully claim that products or services based on intangibles infringe their own intangible rights, including also an evaluation of the costs from defending from such claims;
- Risks associated with product liability which may arise from the use of the intangible; and
- Risks associated with the effective exploitation of the intangible, including uncertainties with respect to the returns to be generated by the intangible.

6.3.5.3 These risks are often connected to specific DAEMPE activities. The accurate delineation of the controlled transaction may determine that the legal owner assumes risks, or that, instead, other members of the group are assuming risks.

6.3.5.4 Risk control and mitigation may be performed by various entities within the group. For example, assume that risk associated with contract R&D activities performed by Company A for the benefit of Company B are properly assumed by Company B, which has the capability to determine the various stage processes together with the performance of the active decision-making function. The way the risk associated with the research and development activity assumed by Company B is mitigated may be subject to general policy-setting elsewhere in the MNE group by Company C, which sets overall levels of financing tied up in the overall R&D project across markets to meet strategic objectives. This wider policy-setting activity cannot be deemed to imply that the R&D risk is allocated to Company C. Instead, Company B assumes this risk.

6.3.5.5 Consistent with the guidance in Chapter 3, if it is established that an associated enterprise contractually assuming the risk both controls, and has the financial capacity to assume, the risk associated with the DAEMPE, then the contractual allocation of risk is respected. If, on the other hand, it is established that an associated enterprise contractually assuming the risk does not control or does not have the financial capacity to assume the risk associated with the DAEMPE, then the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk.

6.3.5.6 In this latter case, should multiple associated enterprises be identified that both exercise control and have the financial capacity to assume the risk, then the risk should be allocated to the associated enterprise or group of associated enterprises exercising most control. Other parties performing control activities should be remunerated based on their contributions to the creation of intangible value. Such compensation would depend on the arrangements between the enterprises and the importance of the control activities performed: it may be appropriate for such a party to share in the potential upside and downside consequences resulting from the outcome of the underlying risk. Alternatively, the contribution might be compensated in a manner that is not contingent on the underlying risk.

6.3.6 Assets

6.3.6.1 According to the arm's length principle, associated enterprises contributing assets to the development or acquisition, enhancement, maintenance, protection and exploitation of an intangible should receive appropriate compensation for doing so. Such assets may include, without limitation, intangibles generally utilized in research, development or marketing activities — such as know-how, customer relationships and physical assets, as well as funding.

6.3.6.2 Funding and risk taking are integrally related in the sense that funding often coincides with the taking of certain risks. For example, a decision to fund R&D in exchange for rights in the potential benefits of that R&D involves the risk that the R&D will be unsuccessful and the funding will be lost. In addition, the larger the amount of the funds provided, the larger the potential impact of the risk on the provider of the funding.

6.3.6.3 It is important to distinguish between the financial risk that is linked to the funding provided (such as, for example, the risk associated with the commitment of capital used to "invest" in a risky intangible development opportunity) and the operational risks associated with the funded activity (such as, for example, the risk associated with the successful performance of the R&D function). Control over a financial risk requires the capability to make the relevant decisions related to the risk bearing opportunity. These include decisions related to taking on, laying off, or declining a risk bearing investment opportunity and the decisions on whether and how to respond to the risks associated with the investment opportunity.

6.3.7 "Ex ante" and "Ex post" Returns

6.3.7.1 It is important to distinguish between ex ante returns and ex post returns. Ex ante returns are anticipated or expected returns at the time a transaction is undertaken. Ex post returns refer to actual returns. There are two aspects, both of which are particularly applicable to intangibles, which are relevant to the difference between ex ante returns and ex post returns: time and risk, as discussed below.

6.3.7.2 *Time*: there is often a significant time lapse between the point in time when a transaction relating to an intangible takes place and the point in time when the actual realization of income from the exploitation of that intangible occurs. For example, a pharmaceutical company may decide in year zero to commit significant resources to undertake R&D that it anticipates will result in a marketable product in year 10. Intimately related to this temporal aspect is risk, for example if the R&D is not successful, then the company might suffer significant losses.

6.3.7.3 *Risk*: the difference between anticipated (ex ante) and actual (ex post) returns can arise from the materialization of a variety of risks such as risk of failure of the R&D, market risk and others. There can be a difference between what was anticipated and what actually occurred. Who should bear the consequences of risk materializing and of the difference, if any, between ex ante returns and ex post returns depends on the extent to which the relevant risk is assumed by the parties. The accurately delineated transaction (for example, the contractual terms, assuming they have substance) will determine which entity or entities assume such risks.

6.3.7.4 The notion that all contributions to value must be appropriately remunerated, as discussed above, is an ex ante concept. An example follows on Contract R&D.

A multinational enterprise decides to invest in the development of a new product. The parent company P makes the investment decision and uses an affiliated enterprise AE which operates an R&D centre to perform some R&D activities in relation to this project. The R&D process is expected to take three years between investment decision and exploitation. The intent of P is to exploit the intangible that will eventually result from the R&D process by licensing it out to third parties.

The contractual relationship between P and AE is a contract R&D services agreement whereby P will remunerate AE for its activities at cost + x%, whether the R&D is successful or not. P assumes the risk of failure of the R&D process. Assume that the actual delineation of the transaction is consistent with the contractual terms.

At the time of the decision to start the R&D activity the anticipated (ex ante) return is 100, consisting of 60 for AE's R&D activity, including future maintenance of the developed intangible (through the cost plus service arrangement) and 40 to reward P for the performance of its DAEMPE functions and assumption of risks, taking into account the passage of time.

Three years later the actual ex post return is in fact 120, due to the materialization of an unforeseen market opportunity. The difference between ex ante and ex post return is 20, attributable to the party that assumed the market risk, in this case P. Thus, out of the ex post return of 120, 60 will be for the contract R&D activity (through the cost plus service arrangement) and 60 for the performance of DAEMPE functions by P.

Alternatively, if the ex post return is in fact 50, the difference between ex ante and ex post return is a negative amount of (50), due to the materialization of a market risk which was assumed by P. Thus, out of the ex post return of 50, the contract R&D activity should still receive 60 (through the cost plus service arrangement) and P will bear a loss of (10).

In both cases, AE's R&D activity is appropriately remunerated, and its remuneration is the same on an ex ante and an ex post basis. This is because it does not bear the consequences (whether positive or negative) of the market risk which it did not assume.

6.3.8 Return to Funding and Associated Financial Risk

6.3.8.1 Assume an entity provides funding and has the ability to control its financial investment risk:

- On an ex ante basis: this entity is entitled to an appropriate risk-adjusted anticipated rate of return on its investment.
- On an ex post basis: the actual return to that entity will depend on the terms of the accurately delineated transaction:
  - One possibility is that the funder receives a share of the difference between ex ante and ex post returns from the investment. In this way, this type of investment is equivalent to an equity investment.
  - Another alternative is that the funder receives a predetermined return (which does not depend on the ex post results from the investment). In this way, this type of investment is equivalent to a debt investment. In practice it may be a fixed rate, or a variable rate which depends on the cost of money but not on the success of the development.

Depending on the terms of the accurately delineated transaction, either type of investment could be consistent with the arm's length principle.

6.3.8.2 On the other hand an entity that provides funding but does not have the ability to control the financial investment risk, i.e. acting as a so-called "cash box" entity, will receive no more than a low risk-free rate of anticipated return. Consistent with the risk-free nature of this low return, the ex post return will be equal to its ex ante return.

6.3.8.3 Example: TechCo Joint Development

Assume that TechCo and High-Yield Co. are members of an MNE and decide to undertake jointly the development of an intangible, which is anticipated to be highly profitable based on TechCo's track record and experienced research and development staff. TechCo will perform, through its own personnel, all the functions expected to be carried out by an entity eager to acquire an independent right to exploit the resulting intangible, including the functions required to exercise control over the risk it has contractually assumed. Assume that the intangible development is expected to take seven years before eventually being successful for commercial exploitation purposes.

Under the contractual arrangement High-Yield Co. will contribute all the funding associated with the development of the intangible, which is anticipated to be an amount of 100 million per year for seven years. TechCo makes all the other contributions to the remaining DAEMPE related to the intangible, whereas High-Yield Co. will control the risk associated with the funding activities amounting to an overall amount of 700 million. Once the intangible is developed, High-Yield Co. will legally own the intangible, which will be licensed to unrelated parties.

Once developed, the intangible is anticipated to result in consolidated profits of 750 million per year, taking into account the years 8 to 17.

Based on the facts and circumstances of the example, High-Yield Co. should earn a risk-adjusted rate of anticipated return based on its R&D funding commitment, which is determined to be 200 million per year (assume that this is an arm's length amount equivalent to a 14 per cent anticipated rate of return). TechCo will earn the profit (or loss) associated with exercising control over operational risk and performing the other DAEMPE, and accordingly, be entitled to the remaining anticipated (ex ante) return, or 550 million per year. Accordingly, in addition to its funding commitment of 100 million in years 1 through 7, High-Yield Co. must pay TechCo the present value equivalent of 550 per year (years 8-17) in recognition of the value of TechCo's DAEMPE contributions. This example does not address the actual (ex post) returns to TechCo and High-Yield Co.

6.3.9 Practical Guidance for Fact-finding in Transactions Involving Intangibles

6.3.9.1 The fact-finding described in section 6.3.1 above is typically performed through a review of written documents, supplemented with interviews with relevant personnel. It is suggested that the following non-compulsory steps are carried out:

- **Step 1: Request written information:** the key objective of this step is to collect as detailed information as possible as to the transfer pricing policy set at the group level, if existing, as well as to collect documents related to key projects;
- **Step 2: Review and analyze** the documents and information collected;
- **Step 3: Conduct interviews** with relevant personnel. Typical questions refer to "Who does what in relation to the local entity's transactions", "Who sets project milestones" or "How is bonus compensation of local personnel attributed"; and

- **Step 4: Analyze** information gathered under Steps 1 to 3 to determine **whether any inconsistency exists between the contractual risk allocation and the actual conduct of the parties** which may potentially impair the accurate delineation of the underlying economic transaction.

6.4 Comparability

6.4.1 The general guidance in Chapter 3 on comparability applies to transactions involving the use or transfer of intangibles. With respect to the comparability analysis intangibles often have unique characteristics. In conducting a comparability analysis, it is therefore important to take these characteristics into account. The following features may be particularly important depending on the case at hand:

- The exclusivity (or non-exclusivity) of the rights to the intangible;
- The geographic territory in which those rights may be exploited;
- The extent and duration of legal protection of the intangible and/or of the rights granted on the intangible;
- The stage of development of the intangible at the time of the transaction;
- Any rights to (future) enhancement of the intangible;
- The options realistically available to each of the parties to the transaction, taking into account the expected future economic benefits arising from it; and
- Potential other comparability factors such as local market features, location savings, assembled workforce and MNE group synergies.

6.5 Selection of the Most Appropriate Transfer Pricing Method

6.5.1 General

6.5.1.1 The principles set out in Chapter 4 apply to select the most appropriate method in the circumstances of the case where the transaction involves a controlled transfer of one or a series of intangibles.

6.5.1.2 In addition, the selection of the most appropriate method in relation to an intangible transaction will depend on the type of transaction involved. For example:

- In transactions involving sales of intangibles, a CUP for the value of the transferred intangible (including the acquisition price method which is a specific application of the CUP Method) or a Discounted Cash Flow approach may be appropriate. See section 6.5.4 below;

- In transactions involving rights to use intangibles, a CUP for the value of the rights to use the intangibles (e.g. value of the licence) may be appropriate. A one-sided transfer pricing method (CPM, RPM or TNMM) can be the most appropriate method if a two-sided functional analysis reveals that one party to the transaction makes all the unique and valuable contributions involved in the controlled transaction, while the other party does not make any unique contribution. In such a case the tested party should be the less complex one; and
- In transactions involving the development of intangibles (e.g. through low risk contract R&D), a cost based approach (whether cost plus or cost based TNMM) may be appropriate. Specific considerations apply, however, to arrangements where the risk of development is shared (including cost sharing or cost contribution arrangements).

6.5.1.3 A PSM may be the most appropriate method if each party to a transaction makes unique and valuable contributions, the parties are highly integrated, or they share significant risks.

6.5.1.4 Supplemental Guidance for applying methods for intangibles are set out below.

6.5.2 Comparable Uncontrolled Price (CUP) Method: Acquisition Price Method in the Case of Transactions Involving Sales of Intangibles

6.5.2.1 With regard to the application of the CUP Method, sometimes the intangibles transferred between associated enterprises were part of a recent acquisition by the MNE group from a third party. For instance, an MNE group acquires a company which owns intangibles. Further to the acquisition, a decision is made to transfer the intangibles owned by the acquired company to another entity that is a member of the MNE group, in order to integrate them with other group intangibles. In such a situation, the consideration, i.e. the price paid for the acquisition of the company from third parties, may represent a useful starting point for determining the arm's length price for the controlled transaction consisting of the transfer of intangibles from the acquired company to another group member under the CUP Method. This type of CUP Method is sometimes referred to as an acquisition price method.

6.5.2.2 For instance, assume PenCo acquires for a price of 100 a 100% equity participation in independent enterprise "Z". Z has a large R&D department developing cutting-edge technology devices but has recorded minimal sales so far. The price of 100 paid by PenCo reflects the value of the technologies developed by Z as well as the capabilities of the latter's personnel to develop further new technologies in the future. Assume that there are no other sources of value contributing to this price of 100 and that the value of' Z's tangible assets is negligible.

6.5.2.3 Immediately following the acquisition, Z transfers all its rights in the developed and partially developed technologies, including patents, trade secrets and technical know-how, to "Y", a subsidiary of PenCo. Y enters simultaneously into a contract R&D agreement with Z, whereby Z's workforce will continue to work solely on the development of the transferred technologies and on the development of new technologies on behalf of Company Y. The agreement provides that Company Z will be remunerated for its R&D services on a cost plus basis, and that all the rights to intangibles developed or enhanced under the R&D agreement will belong to Company Y. Company Y will fund all future research activities and will assume the financial risk that some or all the future research will not lead to the development of successful commercial products.

6.5.2.4 As regards the transfer pricing consequences of such a restructuring, with a specific focus on the arm's length price to be paid by Company Y for the intangibles transferred by Company Z, as well as for the price to be paid for the ongoing R&D services to be provided by Company Z, it is important to identify with specificity the intangibles transferred to Company Y and those retained by Company Z. The valuation done for purchase price allocation purposes, although important for starting the analysis, is not determinative for transfer pricing purposes.

6.5.2.5 In particular, given the above assumption that the price of 100 paid by PenCo represents the value of the technologies developed by Z, as well as the capabilities of the latter's personnel to develop further new technologies in the future, such price should be reflected in the sum of:

- The value of intangible assets transferred to Y; and
- The value of the intangible assets and workforce retained by Company Z.

6.5.2.6 Under the arm's length principle and depending on the facts and circumstances, the CUP Method may be used to determine the remuneration of Company Z paid by Company Y for:

- The transferred intangibles; and
- The present value of the remuneration paid for the R&D services rendered by Company Z.

6.5.3 Cost-based Methods to Value Transfers of Intangibles

6.5.3.1 The use of transfer pricing methods seeking to estimate the value of intangibles based on their cost of development is generally discouraged, as the cost of developing intangibles is seldom a reflection of their value once developed. Accordingly, the use of transfer pricing methods based on their cost of development should generally be avoided. With that being said, where the acquirer has the available option to produce the intangible itself or to have it produced for its own purposes, instead of acquiring it, an intangible valuation based on the estimated cost of reproducing or replacing the intangible (including the value of the time needed to re-develop the intangible rather than acquiring it) may be used.

6.5.4 Valuation Techniques to Value Transfer of Intangibles ("Discounted Cash Flow Approach")

General

6.5.4.1 Where reliable comparable uncontrolled transactions cannot be identified, it may be possible, under certain circumstances, to use valuation techniques to help determine the arm's length price for intangibles transferred between associated enterprises. In particular, the application of valuation techniques based on the calculation of the discounted value of projected future income streams or discounted cash flows (DCF), derived from the exploitation of the intangible being valued, may be useful. Depending on the facts and circumstances, valuation techniques may be used by taxpayers and tax administrations as a part of one of the methods described in Chapter 4 or as a tool that can be usefully applied in identifying an arm's length price. It should be noted that the discussion of DCF Methods in this section is necessarily basic in nature, as a fuller exposition of the theory and practical application of DCFs is outside the scope of this Manual. Corporate finance textbooks provide a fairly solid grounding in this area.

6.5.4.2 Some transfers of intangibles involve risks associated with the uncertainty of future results. For example, an intangible transfer could involve an early stage patent requiring further development, or a fully developed intangible whose future profit potential is very uncertain. These types of intangible transactions by their very nature typically do not have comparable uncontrolled transactions to directly inform the arm's length pricing of the transactions, and so a less direct method may be required. Under the DCF approach the value of an intangible is based on the present value of the anticipated future income or free cash flows attributable to the intangible property. In order to calculate the present value of the future income or cash flows the financial projections and the appropriate discounting rate must be determined.

Circumstances in which a DCF Approach Might be Appropriate

6.5.4.3 Because a DCF is forward looking (as it is based on projected future income), it is most typically undertaken on an ex ante basis (see 6.5.4.17 for a discussion of ex ante versus ex post analyses). That is, a DCF calculation is typically undertaken at the time of the initial intangible transfer, and prior to the actual realization of income associated with the intangible. Many audits are undertaken many years after the initial transfer, however it is difficult to reliably apply a DCF method on an ex post basis. Accordingly, as a starting point it is important to determine if the taxpayer has undertaken at the time of, or prior to, the intangible transfer, an analysis of the anticipated profitability of the intangible (i.e. financial projections), and an analysis of the anticipated risks involved. While this type of analysis is not undertaken for all intangibles, it is more likely that such an analysis may have been undertaken where the intangible is relatively important (i.e. potentially valuable) to the multinational and/or is susceptible to reasonably direct financial tracking. For example, multinationals often evaluate potential projects to develop specific intangibles, such as pharmaceutical products from a particular molecular compound, or "next generation" software. Financial projections are sometimes used—often for non-tax reasons—in order to gauge the anticipated profitability of a project to determine its viability. These evaluations could be undertaken at any stage, or in several stages, of development. This information could be helpful in determining the arm's length value of the intangible at the time of the transfer, and accordingly, be useful in determining the arm's length price for the transaction.

6.5.4.4 A DCF analysis may be undertaken by taxpayers or tax administrations at a time subsequent to the intangible transfer in order to inform the analysis of the value of the intangible at the time of the transfer, but the reliability of this approach may be reduced. This is because, to the extent that the analysis is undertaken after risks have played out, it is difficult to assess the perception of those risks at an earlier time, such as the time of the transfer. See further section 6.5.4.17 below.

6.5.4.5 Financial projections: Financial projections[58] should reflect the best estimate of the items projected, which may include sales, development costs, cost of sales and operating expenses. Given that there is typically uncertainty in possible outcomes, the financial projections may be based on a probability-weighted average of possible outcomes, as illustrated in the example in section 6.5.4.7.

6.5.4.6 The length of the period for which income or cash flow is to be determined depends on the useful life of the intangible. For instance, if the discounting period is ten years, then the income or cash flow projections should also be determined for a ten-year period. The useful life of an intangible is the entire period during which the exploitation of the intangible is anticipated to occur. Exploitation of intangibles includes any direct or indirect use or transfer of the intangible, including use without further development, use in the further development of the intangible (and any exploitation of the further developed intangible), and use in the development of other intangibles (and any exploitation of the other intangibles when they are developed).

6.5.4.7 Assume that a project is undertaken in order to develop a genetically modified grass for livestock grazing. The project will involve R&D undertaken for two years. If the R&D is successful, then the intangible will be exploited in years three through five, after which the intangible is anticipated to be worth nothing due to anticipated competitive pressures. While the future R&D expense is fairly certain, the outcome of the R&D is less certain, so the financial projections for sales are uncertain. Accordingly, the taxpayer prepares three sets of sales projections associated with an optimistic outcome, an expected outcome, and a pessimistic outcome. The taxpayer estimates that the expected outcome is most likely to occur, and that both the optimistic scenario and the pessimistic scenario are less likely. Accordingly, based on its technical and business judgment, the taxpayer assigns a 50 per cent probability of sales achieving the expected outcome, a 25 per cent probability of sales achieving the optimistic outcome, and a 25 per cent probability of sales achieving the pessimistic outcome. Assume further that production costs are estimated to be

[58] DCF methods are typically based on projections of cash flows. Accrual based measures of income may not properly reflect the timing of cash flows, which can create a difference in outcome between an income and cash-flow based approach. However, the use of income projections rather than cash-flow projections may, in some cases, yield a more reliable result in a transfer pricing context as a practical matter. Care must be taken, however, to ensure that either income or cash flow measures are applied in a consistent manner and in appropriate circumstances. References to cash flow in this document should therefore be read broadly to include both cash flow and income measures, appropriately applied.

equal to 40 per cent of sales and operating expenses are estimated to be equal to 20 per cent of sales. The taxpayer determines the most reliable financial projections by performing a probability-weighted calculation as follows:

Table 6.T.1
Expected Scenario: 50% probability of occurring

Year	**1**	**2**	**3**	**4**	**5**
Sales			250	250	250
R&D	100	100			
COGS			100	100	100
Operating expenses (SGA)			50	50	50
Operating income	(100)	(100)	100	100	100

Table 6.T.2
Optimistic Scenario: 25% probability of occurring

Year	**1**	**2**	**3**	**4**	**5**
Sales			750	750	750
R&D	100	100			
COGS			300	300	300
Operating expenses (SGA)			150	150	150
Operating income	(100)	(100)	300	300	300

Table 6.T.3
Pessimistic Scenario: 25% probability of occurring

Year	**1**	**2**	**3**	**4**	**5**
Sales			0	0	0
R&D	100	100			
COGS			0	0	0
Operating expenses (SGA)			0	0	0
Operating income	(100)	(100)	0	0	0

Table 6.T.4

Probability-weighted Financial Projections

([Table 1 times 50%] PLUS [Table 2 times 25%] PLUS [Table 3 times 25%])

Year	**1**	**2**	**3**	**4**	**5**
Sales			312	312	312
R&D	100	100			
COGS			125	125	125
Operating expenses (SGA)			62	62	62
Operating income	(100)	(100)	125	125	125

Discount Rate

6.5.4.8 A discount rate is used to convert the projected future year results to an equivalent present value. The discount rate is intended to compensate for the time and risk associated with the projected income or cash flows. A discount rate should be used that most reliably reflects the market-correlated risks of the projected income or cash flows, providing a measure of the appropriate anticipated return to the risk undertaken. For example, if a particular income or cash flow is projected to occur with complete certainty, the discount rate should only take into account the time required to receive such income or cash flows. In this case, a risk-free rate might provide the most reliable discount rate e.g. long-term government bond rates for the time value of money invested. On the other hand, if the projected income or cash flows are highly uncertain due to risk, those risks should be taken into account when determining the applicable discount rate. In such situations, the discounting rate might be calculated based on a higher rate than the risk-free rate, to adjust for risk premium.

Technical Note: “Ex ante” Versus “Ex post” Financial Projections

“Ex post” financial projections are, of course, not really projections at all, but the actual financial results. Assume, for example, that the actual results of the project in the Example above turn out to be what was considered the optimistic scenario at the outset of the project, reflected in Table 6.2. From the ex post perspective of year five there is no risk—there is only the certainty of what actually happened. If these financial results are used in a DCF model to determine the value of the intangible at the beginning of the project in year one, there are two potential biases introduced with respect to risk.

First, using actual financials effectively presumes that they correspond to anticipated financial projections as of year one with perfect certainty. That is, using these financials does not capture any of the real uncertainty of the project at its outset. Second, there is the question of what discount rate should be applied to the financial projections. Should it be the risk-free rate, reflecting the certainty of the actual outcomes? It would seem not, as this would certainly exacerbate the risk bias. In short, since risk is a key element in determining the value of the development of an intangible, assessment of such risk after the fact is difficult and inherently subjective, as it is difficult to discount the risk of what actually happened. As an illustration of this concept, what is the amount that someone should have paid yesterday for a lottery ticket number that happens to win $580 million today? The answer is the price of the lottery ticket (e.g. $1). While a person might understandably assess that the ticket was worth more yesterday (after all, it turned out to be the winning ticket), this would reflect ex post risk bias.

It is important to note that it is an entirely different question as to whether the financial projections and assessment of risk undertaken by a taxpayer are in fact truly reliable, or whether they might reflect opportunistic use of information asymmetry over the tax authority, such as through deliberate undervaluation of the financial projections or a deliberate overestimate of the anticipated risk. In those narrow situations, it might be appropriate to use actual financials to value intangibles. See further paragraph 6.5.4.16 to 6.5.4.17. As an illustration, if a person was reliably “tipped off” that a certain lottery ticket number would be picked tomorrow, she would certainly be willing to pay more—much more—than $1 for that lottery number today!

Other Aspects of DCF Methods

6.5.4.9 Where the purpose of the valuation technique is to isolate the projected cash flows associated with an intangible, it may be necessary to evaluate and quantify the effect of projected future income taxes on the financial projections. Tax effects to be considered include: (i) taxes projected to be imposed on future cash flows, (ii) tax amortization benefits projected to be available to the transferee, if any, and (iii) taxes projected to be imposed on the transferor as a result of the transfer, if any.

6.5.4.10 Applications of DCF approaches require the determination of realistic and reliable financial projections, growth rates, discount rates, the useful life of the intangibles and the tax effects of the transaction. In some circumstances, where intangibles contribute to continuing cash flows beyond the period for which reasonable financial projections exist, a "terminal value" for the intangible-related income or cash flows may be calculated. Where terminal values are used the assumptions underlying their calculation should be clearly documented, particularly the assumed growth rates. It is important to note that a small change to one or more of the valuation parameters above can lead to huge differences in the valuation results. Therefore, it is crucial to require taxpayers to clearly state their presumptions regarding the important parameters, and, when needed, make some sensitivity analysis which presents the consequential change of valuation results of using alternative presumptions.

Technical Note: Terminal Value

Financial forecasting is difficult, and forecasts tend to become less reliable and more cumbersome the longer the projection period. It is not necessary to estimate financial projections forever. After providing financial projections for a number of years, a "terminal value" can be used at the point of time in which the analyst expects stable growth rates. For example, if year-by-year financial projections are estimated out to year 10, then a terminal value in year 11 is discounted at the appropriate rate—that is, divided by (1+d)11, where d is the discount rate, to determine the present value of the terminal value. The terminal value is defined by the financial projection for an item (e.g. net income) for year 11 divided by (d-g), where g is the assumed growth rate of the item. The present value of the terminal value is added to the present value of the projections through year 10.

Terminal values are mathematically equivalent to the financial projections continuing in perpetuity. While this may seem at first sight to unrealistically overvalue intangibles (after all, it seems quite unlikely that intangibles will have value forever), terminal values are actually a useful shorthand when detailed out-year financial projections become unreliable, and two aspects of terminal values should be kept in mind. First, the terminal value itself is discounted, and the further out in years the terminal value is estimated, the more significant is this factor. For example, at a discount rate of 10 per cent, the discount factor in year zero of a terminal amount of $100 in year 10 is 1/(1.1)10, or $38.6. Second, things such as anticipated obsolescence, anticipated future competitive pressures and other aspects reflecting the anticipated diminution of value over time of an intangible can be reflected in "g", the growth factor. A negative value of g, for example, can be used to reflect the expectation that competitive pressure will eventually and permanently reduce the anticipated profitability of the intangible.

6.5.4.11 Furthermore, it is necessary to take into account the present value calculated from the perspective of both parties to the controlled transactions. The arm's length price should fall within the range of expectations of the two parties.

6.5.4.12 Assume that the facts are the same as the example at 6.5.4.7. Assume further that:

- Company A sells the entire rights to the (potential) genetically modified seeds to Company B prior to the commencement of the R&D project, and Company B will fund the development activities. Assume that Company B has the ability to control, and the financial capacity to undertake, such financial investment risk;
- The R&D will be performed by Company A in Country A, and the intangible will solely be exploited in Country B;
- Company A is uniquely qualified to undertake the R&D because of its highly skilled workforce, and its use of valuable pre-existing intangibles related to other genetically modified seed patents that it owns;
- Company B will produce and sell the seeds. Assume that the arm's length remuneration for this activity is a 5.3 per cent mark-up on total costs (CGS + SGA);
- Through the functional analysis it is determined that Company A has the realistic alternative of developing the intangible itself (that is, retaining the rights to the intangible) and exploiting it in Country B. Assume further that Company B has the ability to control its investment risk; and
- It is determined that the appropriate discount rate, which reflects the market correlated risks associated with the project, is 11 per cent. This is determined with reference to the weighted average cost of capital of unrelated companies that engage in similarly risky projects.

6.5.4.13 Under these assumptions, Company A would not surrender its rights to the intangible for an amount that would make it worse off compared to its realistic alternatives. This would be reflected in the table 6.T.5 below:

Table 6.T.5

Present Value Calculation

Year	**Present Value at 11% Disc. Rt.**	**1**	**2**	**3**	**4**	**5**
Sales				312	312	312
R&D		100	100			
COGS				125	125	125
Operating expenses (SGA)				62	62	62
Operating income	77	(100)	(100)	125	125	125
Arm's length return to manufacturing and sales	24	0	0	10	10	10
Operating income attributable to intangibles	53	(100)	(100)	115	115	115

6.5.4.14 The present value of operating income, discounted at an 11 per cent rate, is 77. However, of that amount, the present value of the assumed arm's length return to manufacturing and selling, undertaken by Company B, is 24. Under these Assumptions, Company A would not surrender the rights to the intangible for less than an amount equal in present value to 53.

Technical Note: Simplifying Assumptions

There are a number of important simplifying assumptions made for the purpose of the example:

- First, for example, discount rates are typically determined on an after-tax basis, and should typically be used to dizscount after-tax income flows. In the example, the discount rate is used to discount pre-tax cash flows. This is not generally appropriate, although it may be appropriate in particular circumstances;
- Second, for ease of calculation all financial flows are assumed to occur at the end of each period; and
- Third, the financial projections are assumed to end at the end of year five. Often financial projections extend beyond the years explicitly documented through the use of tools such as terminal value calculations.

6.5.4.15 It is important to consider the Assumptions and motivations that underlie particular applications of DCF approaches. For example, some valuation assumptions may reflect conservative assumptions and estimates of the value of assets reflected in a company's balance sheet. This inherent conservatism can lead to definitions that are too narrow for transfer pricing purposes and valuation approaches that are not necessarily consistent with the arm's length principle. Caution should be exercised in accepting valuations performed for accounting purposes as necessarily reflecting arm's length prices or values for transfer pricing purposes without a thorough examination of the underlying assumptions. In particular, valuations of intangibles contained in PPAs (purchase price allocations) performed for accounting purposes are not determinative for transfer pricing purposes and should be used with caution and careful consideration of the underlying assumptions.

Use of DCF Methods by Tax Administrations

6.5.4.16 Because DCF methods are properly undertaken on an ex ante basis, and because tax audits typically occur at a later time, it is often the case that tax administrations must rely at least partially on the taxpayer's initial DCF analysis in evaluating the arm's length nature of a transaction involving intangibles. A relevant question is how such information can be used by tax administrations, and how this information might be supplemented as part of a fact-finding exercise.

6.5.4.17 As discussed in section 6.5.4.3, one of the characteristics making the application of a DCF analysis plausible in the first place is that the intangible is susceptible to reasonably direct financial tracking. If this characteristic applies to financial projections, it is also likely to apply to the actual financial results from the intangible (that is, to ex post results). With this information, tax administrators should be able to compare anticipated profitability with actual profitability. It is important to note that there will inevitably be discrepancies between anticipated results and actual results, because after all, risk and uncertainty are real. However, the information can be used to assist in fact finding, raising questions that tax administrations may bring up with taxpayers, such as:

- How do the actual results compare to the anticipated results? Are the actual results within or outside the anticipated range of potential results (e.g. the different forecasts in the probability-weighted financial projections in the Example above)? What explains the divergence?
- What is the company's track record with respect to other relevant capital budgeting decisions (i.e. application of ex ante DCFs done

for other intangibles)? Does the company tend to systematically outperform or underperform its estimates of anticipated profitability?

- On what basis was the initial assessment of risk undertaken, both with respect to the probability-weighted financial projections and the determination of an appropriate discount rate? Is there documentation prepared at the time of the initial assessment?
- Is the discrepancy between anticipated results and actual results likely to continue in subsequent years (that is, years beyond the audit year)? If so why or if it is not likely to continue why not?
- Have there been unanticipated events subsequent to the initial transaction that wholly or partially explain the discrepancy?

6.5.4.18 These questions may assist the tax administration in determining whether the ex ante analysis undertaken by the taxpayer truly reflected an appropriate assessment of the anticipated profitability and risk associated with the intangible. It is important to stress that it is generally inappropriate for a taxpayer or tax authority to undertake a DCF analysis based on ex post data in order to formulate an assessment of the ex ante value of an intangible. This is because it is difficult and often subjective to determine the ex ante view of risks after the risks have already materialized. Such an analysis may constitute an inappropriate use of hindsight.

6.5.4.19 However, there are situations in which, for transactions involving intangibles whose valuation is highly uncertain at the time of the transaction, and that are susceptible to opportunistic use of information asymmetry between the taxpayer and the tax administration, ex post outcomes can provide a pointer to tax administrations as to the arm's length nature (or otherwise) of the ex ante pricing arrangement agreed upon by the associated enterprises, and the nature of uncertainties at the time of the transaction. Section D.4 of Chapter VI of the OECD Transfer Pricing Guidelines discusses these situations at paragraphs 6.186 to 6.195, and the discussion and conclusions of that section are considered valid in the context of this Manual.

Other Applications of DCF—Using DCF to Set Ex ante Contingent Payments

6.5.4.20 A DCF can be used to determine on an ex ante basis an arm's length contingent payment (e.g. a royalty rate on anticipated sales), which is then applied to the actual contingent payment base (e.g. the same royalty rate on actual sales). As with all methods, the application of this approach is subject to the most appropriate method rule. However, in the event that more direct comparables (e.g. comparable unrelated license rates) are not available, a less direct measure based on the anticipated profitability of the intangible might be used.

6.5.4.21 Assume that the facts are the same as in the Example at section 6.5.4.12 to 6.5.4.13. However, Company B agrees to compensate Company A on a contingent basis, based on sales. Based on the results in Table 6.T.5, a royalty rate of 36.9 per cent on anticipated sales will result in a present value of 53 to Company A. That is, a royalty rate of 36.9 per cent applied to anticipated sales of 312 in each of years three, four and five yields 115 in each of years three, four and five. Taking into account the 100 in R&D costs undertaken by A in years one and two, the present value of this income stream is 53. Accordingly, the arm's length royalty rate is determined to be 36.9 per cent, and this rate is applied to actual sales (which may differ from anticipated sales).

Conclusion on Valuation Techniques

6.5.4.22 It is not the intention of this Manual to set out a comprehensive summary of the valuation techniques used by valuation professionals. Similarly, it is not the intention of the Manual to endorse or reject one or more sets of valuation standards used by valuation or accounting professionals or to describe in detail or endorse one or more specific valuation techniques or methods as being especially suitable for use in a transfer pricing analysis. However, where valuation techniques are applied in a manner that gives due regard to the principles outlined in this Manual, to the specific facts of the case, to sound valuation principles and practices, and with appropriate consideration of the validity of the assumptions underlying the valuation and the consistency of those assumptions with the arm's length principle, such techniques can be useful tools in a transfer pricing analysis.

Profit Split Method (PSM)

6.5.4.23 In some circumstances a transactional PSM can be utilized to determine the arm's length conditions for a transfer of intangibles or rights in intangibles. See further 4.6.3. In determining whether a transactional PSM should be selected as the most appropriate to the transaction, the availability of reliable and sufficient data regarding relevant profits from the transaction and factors to be used to divide them should be taken into account, as this can affect the reliability of the method.

6.5.4.24 Where a PSM is found to be the most appropriate method in a transaction involving the transfer of an intangible or rights in an intangible, the following main questions need to be addressed:

- What are the relevant profits from the transaction that will be split? This may require segmenting the parties' profit and loss accounts to focus on the results of the transaction only;
- Will the split be based on ex ante or ex post profits? The profit split approach selected must consider which party/parties assume(s) the risks that ex post results may differ from ex ante profits; and
- What are the appropriate splitting factor(s)? This should depend on the expected contributions by each party to the transaction.

6.5.4.25 Notwithstanding the above, the transfer pricing methods most likely to prove useful in transactions involving the use or transfer of one or more intangibles are the CUP and the transactional Profit Split Methods. Valuation techniques can be useful tools to supplement the application of the above-mentioned methods.

6.5.4.26 Where information regarding reliable comparable uncontrolled transactions cannot be identified, the arm's length principle requires the use of another method to determine the price that uncontrolled parties would have agreed under comparable circumstances. In such a situation, it is important to consider the following factors:

- The functions, assets and risks of the respective parties to the transaction;
- The underlying business reasons for engaging in the transaction;
- The options realistically available to each of the parties to the transaction, including the expected future economic benefits arising from it;
- The value-adding elements embedded in the intangibles, with a specific focus on the relative profitability of the products or services to which the intangibles relate; and
- Other comparability factors such as
  - local market features;
  - location savings;
  - assembled workforce; and
  - MNE group synergies.

7 Cost Contribution Arrangements (CCAs)

7.1 Introduction

7.1.1 This chapter provides guidance on the use of cost contribution arrangements (CCAs) and the application of the arm's length principle to CCAs for transfer pricing purposes. CCAs are contractual agreements between associated enterprises in an MNE in which the participants share certain costs and risks in return for having a proportionate interest in the expected outcomes arising from the CCA. CCAs may also include independent parties. CCAs may be used for a broad range of purposes such as acquiring or creating tangible assets, acquiring or creating intangibles, and providing intragroup services. In relation to intangibles, the CCA will set out the interest of each participant in the intangibles to be developed. For services, the CCA will set out the services that each participant is entitled to receive. For CCAs involving tangible assets, the CCA will set out the interest of each participant in the tangible assets.

7.1.2 A CCA will satisfy the arm's length principle if a participant's share of contributions to the CCA is in proportion to its share of expected benefits under the CCA.

7.1.3 CCAs offer significant administrative advantages. As associated enterprises perform intragroup services for other group members and also benefit from intragroup services provided by other group members, a CCA can provide a mechanism for replacing a web of separate intragroup arm's length payments with streamlined net payments based on aggregated benefits and aggregated costs associated with the services. Similarly, a CCA for sharing in intangibles development can eliminate the need for complicated cross-licensing payments and replace it with a more streamlined sharing of contributions and risks, effectively achieving joint ownership of the resulting intangible.

7.1.4 CCAs are used to develop future benefits such as tangible assets or intangibles, or to provide intragroup services. MNEs use CCAs to share the costs and risks of developing intangibles. These activities involve risk as the expected benefits may not be realized. For example, it is uncertain whether research and development will result in the creation of an intangible which can be exploited by the participants. Given the degree of risk involved, the sharing of costs and expected benefits may be a preferred approach. Moreover, a single associated enterprise may not have the resources or the capacity to individually carry out the development by itself. Another advantage of a CCA is the flexibility to make contributions in the form of tangible assets, intangibles and services. A CCA may provide that the participants are allowed the exclusive right to exploit the intangible in specific countries or regions. A participant in a CCA must be able to use its interest in the intangibles and thus the participants cannot be required to pay royalties for the use of intangibles developed under the CCA.

7.1.5 Broadly, there are two distinct categories of CCAs: arrangements for sharing in the costs and benefits of inter-company services (service sharing arrangements), and arrangements established for the development, production, or obtaining of intangibles or tangible assets (development arrangements, most typically intangibles development arrangements). Both types of arrangements involve the sharing of contributions and the sharing of anticipated benefits. Contributions may be in the form of cash, tangible assets, intangibles, and services. While both types of CCAs derive from the same underlying framework of sharing relative contributions in proportion to relative benefits, the motivation for these arrangements and some of the practical issues of implementing the arrangements may not be the same.

7.1.6 In service sharing arrangements, for example, an MNE may decide to centralize its human resources operations or information technology (IT) function in an associated enterprise so the participants will share the costs of providing these services. An advantage of intragroup service CCAs is that they provide for economies of scale to the participants, resulting in a lower proportional cost for these services than if each participant were providing the services in-house. For example, an MNE may decide to have its IT services provided by a participant in a low-cost country which has an established history of being an international leader in IT. The centralization of IT provides the group with access to high quality IT services provided at a lower cost through economies of scale and potential location savings.

7.1.7 Some of the savings from centralizing functions may arise from preventing unnecessary duplication of functions within an MNE. The savings that arise from centralizing services provided in an associated enterprise will usually be immediate. The services that may be the subject of a CCA include management, administrative and technical services, marketing and purchasing of raw materials or products.

7.1.8 On the other hand, for example in an intangibles development CCA, participants within an MNE may decide to share in the costs, risks and potential benefits from undertaking a project to develop a new product such as a pharmaceutical product. Contributions may include patents and other existing intangibles relevant to the development, research and development services, and use of laboratories. Potential benefits might include the exclusive rights for each of the participants to exploit the intangible in its own market. There may be a significant time lag between development activities and the creation and exploitation of any resulting intangibles.

7.2 CCA Features

7.2.1 The key characteristic of CCAs is that the participants agree to share the proportionate costs of creating or acquiring tangible assets, creating or acquiring intangibles, or providing services. They accordingly agree to have corresponding proportionate interests in the tangible assets, intangibles or services created by the CCA. Participants should thus share the benefits in a way that is consistent with their contributions to the CCA. The predictability of the benefits of participating in CCAs varies. In some CCAs the benefits may be predictable at the outset but in other cases there may be uncertainty about the outcome. For example, it may be highly uncertain whether research and development will result in the creation of intangibles such as patents, know-how or IT software. In relation to services, a CCA may fail to provide the predicted benefits from economies of scale as a result of certain unexpected contingencies.

7.2.2 The benefits for an MNE in using a CCA may include:

- ➢ Exploiting economies of scale and global corporate efficiency for commonly required services;
- ➢ Reducing duplication within an MNE;
- ➢ Increasing operational effectiveness through shared activities and synergies within the MNE;
- ➢ The sharing of risks among the CCA participants; and
- ➢ Exploiting the knowledge of the participants through the sharing of know-how and best practices.

7.2.3 A participant in a CCA involving intangibles is entitled to use its interest in the intangibles in accordance with its share of the intangible and cannot be required to pay a fee or royalty to use its interest in the intangible. This is the case even where legal ownership is held by one associated enterprise on behalf of the group.

7.2.4 The features of CCAs are:

- Having at least two participants;
- A sharing of costs or other contributions between the participants based on anticipated benefits;
- Each participant should have a reasonable expectation of benefitting from taking part in the arrangement (mutual benefit);
- The details of the arrangement are documented;
- The form of the CCA and the economic substance are consistent; and
- Arrangements exist for the departure of participants ("buy out") from the CCA and the entry of new participants to the CCA ("buy in").

7.3 Participation in a CCA

7.3.1 Under the arm's length principle, a participant in a CCA must expect to benefit from participating in the CCA. In particular, the participant must have a specific interest in the tangible assets, intangibles or services of the CCA activity and must be capable of using those tangible assets, intangibles or services. The benefit that a CCA participant expects to receive is based on an objective prediction. Nevertheless, the decision is based on an expectation because of the associated uncertainty and there is no requirement that the CCA benefits are realized as CCAs often involve risk.

7.3.2 In some industries, the facts and circumstances indicate that the research and development project is risky and may fail to realize benefits. For example, in the pharmaceutical industry many research and development projects may fail to result in patents and products which can be exploited commercially. Nevertheless, the pharmaceutical industry is competitive and MNEs must continue to engage in research and development to remain competitive, as the rewards flowing from the development of a new drug can be very significant. The facts and circumstances suggest that although there is a high risk that an individual pharmaceutical research and development CCA may fail to actually provide benefits to the participants, this may simply reflect the playing out of risks, and is not in itself indicative that the CCA does not satisfy the arm's length principle.

7.3.3 The CCA activities may be carried out by one or more participants, or the activity may be undertaken by an associated enterprise which is not a participant. If a non-participant associated enterprise carries out the CCA activity, under the arm's length principle it will require consideration for the work it engages in and it will not, for example, have an interest in any resulting intangibles or tangible assets. The consideration would be determined using a functional analysis and applying the appropriate transfer pricing methods in the Manual.

7.4 Valuing CCA Contributions

7.4.1 To determine if a CCA satisfies the arm's length principle, it is necessary to determine the value of each participant's contributions. All contributions must be identified and valued generally at the time the contributions are made. A participant's contributions may be in the form of cash, tangible assets, intangibles or services. The guidance provided in this Manual is to be used in valuing contributions and taking into account the mutual sharing of risks by the participants and the expected benefits that will be derived by the participants.

7.4.2 Contributions to a CCA may take many forms. For service sharing arrangements, contributions primarily consist of the performance of the services. For development CCAs, contributions typically include the performance of development activities (e.g., research and development or marketing) and often include additional contributions relevant to a development CCA such as other pre-existing intangibles that will contribute to the development of a CCA intangible.

7.4.3 There is a difference between current contributions and pre-existing contributions. Examples of pre-existing contributions would include the contribution of patented technology with pre-existing value that is useful towards the development of the intangible which is the subject of the CCA, or the contribution of a tangible asset that had been acquired by one of the participants some time before the commencement of a CCA. Contributions of the pre-existing value of tangible assets and intangibles should be valued using the arm's length principle in this Manual as outlined in Chapter 6.

7.4.4 Current contributions, on the other hand, are ongoing contributions. An example would be the performance of research and development services directed to the objective of the CCA. Such services would be valued on the basis of the functions performed by the participants, bearing in mind the assets used or contributed and risks assumed. The current value of contributions should be determined in accordance with the arm's length principle in this Manual.

7.4.5 Although under the arm's length principle all contributions should be measured at value, it may be easier for participants to measure current contributions at cost. If this approach is adopted, the value attributed to the pre-existing contributions should recover the opportunity cost of the ex ante commitment to contribute at cost resources to the CCA. For example, a contractual arrangement (i.e. the CCA) that commits an existing workforce to undertake work for the benefit of the CCA should reflect the opportunity cost of alternative R&D endeavours (e.g. the difference between the value of the next most valuable use of the research and development staff over anticipated research and development costs) if the research and development performed by the CCA is to be valued at cost. In making this determination it is important not to double count different contributions of value (e.g. the value of the workforce and the value of the intangible contributions).

7.4.6 In certain situations, current contributions may be valued at cost as a practical method of valuing the relative value of the current contributions, e.g. if the difference between value and costs is insignificant. However, if contributions involve a combination of tangible assets, intangibles and services, measuring the current contributions at cost may be unreliable for valuing relative contributions and may result in non-arm's length results. If it is claimed that the conditions of a CCA reflect those in comparable uncontrolled transactions, and the uncontrolled transactions use cost for valuing contributions, then the comparability of all the significant economic features of the controlled and uncontrolled transactions must be examined to ensure that the CCA and the uncontrolled transactions are comparable. Another issue that needs to be considered in comparing a CCA to uncontrolled transactions is whether other payments are made in the uncontrolled transactions, such as milestone payments.

7.4.7 In some situations budgeted costs may be used for valuing contributions. Budgeted costs may be justified on the basis that contributions to a CCA will reflect expected benefits. There are usually differences between budgeted costs and actual costs in a CCA. A key question is therefore to determine which participants bear the risk that actual costs may be greater or lower than the budgeted costs. Arm's length parties will usually set out how to deal with the differences between budgeted costs and actual costs. Moreover, independent parties are likely to agree on the factors that are taken into account in developing the budget and how unforeseen anomalies are to be treated. If there are significant differences between budgeted costs and actual costs, the reasons for the differences should be examined to ensure that the CCA has not been significantly altered so that the changes may not benefit some of the participants.

7.4.8 As stated above, all contributions by participants to a CCA must be recognized. Contributions to be considered include contributions used exclusively for the CCA and also contributions used partly in the CCA and partly in the participant's other business activities. The apportionment of valuation of contributions may be difficult in some situations. A participant may contribute the use of its business premises including tangible assets such as plant and equipment, and the participant may also provide certain services to the CCA. The participant may also be using the business premises and tangible assets concurrently for its own business. In these circumstances the arm's length value of the use of the business premises and the access to the plant and equipment must be determined. The appropriate valuation would be the arm's length rent for non-exclusive possession of business premises and the use of plant and equipment. The apportionment of contributions for valuation purposes should be based on the facts and circumstances and accepted accounting principles. If material changes occur during the life of the CCA, adjustments will be required to the apportionment. How these are treated for tax purposes will depend on domestic law.

7.4.9 In many jurisdictions governments provide specific tax incentives and subsidies for research and development, which raises the issue of whether these incentives should be taken into account in determining a participant's contributions to a research and development CCA. The alternative approaches are to value the participant's contribution and disregard the subsidy, or to value the contribution taking into account the effect of the subsidy. Under the former approach, the participant enjoys the full benefit of the subsidy itself. Under the latter approach the participant's contribution is reduced by the effect of the subsidy and in effect all participants share the benefit of the participant's subsidy. The determination under the arm's length principle depends on whether independent enterprises would have engaged in these activities in the same circumstances.

7.5 Predicting Expected Benefits

7.5.1 For an associated enterprise to participate in a CCA it must have an expected and identifiable benefit. An associated enterprise's expected benefit is important in determining the enterprise's contribution and whether the allocation method (e.g. allocation key) used by the MNE is acceptable for the tangible assets, intangibles or services. An associated enterprise's contributions must reflect its anticipated share of expected benefits in order to satisfy the arm's length principle. An independent enterprise would not engage in a CCA unless it is able to identify a proportionate expected benefit. The notion of expected benefit is broad and means an economic advantage that may be in the form of reduced costs, increased income or maintaining its commercial and financial position. For intragroup services one of the main advantages which would be expected from the centralized provision of services would be the cost reduction achieved through economies of scale. The analysis of the expected benefits must be based on an associated enterprise's facts and circumstances.

7.5.2 "Allocation keys" are often used by MNEs as an indirect method to approximate the respective future benefits of each participant in a CCA. An allocation key may be based on factors including: turnover, gross profit, net profit, the number of employees and capital. The allocation key used is a proxy for determining the nexus between the contribution and the participant's entitlement in expected benefits; the factors to be used must be determined on the facts and circumstances of the CCA.

7.5.3 The determination of a participant's contributions should be based on objective projections of its expected benefits and the respective advantages that they will provide to the participants. The projections should reflect projections that would have been made by independent parties in similar circumstances. A tax authority reviewing projections should only review them on the basis of information available to the participants rather than using hindsight which would be deemed unfair. In addition, CCAs should provide for adjustments to be made to contributions during the course of the CCA on a prospective basis to reflect changes in the ratio of the expected benefits of the participants.

7.5.4 For some CCAs, such as for intangibles development, the benefits from the CCA will be realized in the future, and the time lag between commencement and realization may be significant. Accordingly, it can be difficult to measure the expected benefits flowing from research and development CCAs. Discounted income or cash flow methods are often used (see section 6.5.4). Under the arm's length principle, a participant's contributions to a CCA must be consistent with its share of the expected benefits. This requires a direct approximation of a participant's expected benefits and ensuring that its relative contributions reflect its relative expected benefits. Consequently, if a participant is expected to receive a significant direct benefit if the goals of the CCA are realized, the participant should make a significant contribution.

7.5.5 **Example: Development of New Technology**

> Assume that Company A and Company B enter into a CCA in year one to develop new technology. At the inception of the CCA it is projected that the development process will take five years and that once the new technology is commercialized in year six Company A will receive 75 per cent of the benefits and Company B will receive 25 per cent of the

benefits. Total development costs are 100 each year.

In years one, two and three, Company A pays 75 in CCA related costs and Company B pays 25 in CCA related costs. At the end of year three, regulatory changes take place in the expected market for the new technology in Company A's territory. As a result of those changes, it is projected in year four and thereafter that Company A will derive 50 per cent of the total benefits and Company B will also derive 50 per cent of the projected benefits over the useful life of the technology being developed. As a result of the changes in total projected benefit shares, Company B should make balancing payments to Company A equal to 75 (the difference between 25 per cent and 50 per cent of the total costs incurred in years one, two and three). This balancing payment should be made in year four. Also in year four and year five, based on the new benefit ratio calculation, Company A and Company B should each pay 50 of the current annual CCA related costs.

Thus, at the end of the development period, both Company A and Company B would have paid 50 per cent of the CCA development costs and each would anticipate receiving 50 per cent of the benefits of exploiting the new technology, as follows:

Table 7.T.1

	Year 1	**Year 2**	**Year 3**	**Balancing payment Year 4**	**Year 4**	**Year 5**	**Total**
Company A	75	75	75	(75)	50	50	250
Company B	25	25	25	75	50	50	250

7.6 Non-arm's Length CCAs

7.6.1 General

7.6.1.1 A CCA will fail the arm's length test if the participant's contributions are inconsistent with their share of the expected benefits. As a consequence, other participants will be receiving a corresponding excessive share of the benefits and, accordingly, an adjustment based on the facts and circumstances of the case may be required. The potential adjustments a tax authority may make in the case of a participant failing to comply with the arm's length principle are to alter the contributions or to disregard the terms of the CCA.

7.6.2 Balancing Payments

7.6.2.1 A CCA will satisfy the arm's length principle if the value of every participant's proportionate share of the total contributions is reflected in the participant's share of the expected benefits. If a participant's share of overall contributions is inconsistent with the participant's share of the expected benefits, the contributions of at least one participant are excessive and, correspondingly, the contributions of at least one other participant will be inadequate. In this situation, under the arm's length principle a balancing payment is required by the participants whose contributions are inadequate. The balancing payment will increase the value of contributions of the payer and decrease the value of contributions by the payee.

7.6.2.2 Participants may also make an additional contribution to a CCA if the participant's proportionate contributions are too low when compared to its expected benefits. Adjustments may be the result of a periodic review of a participant's contributions and its relative share of the expected benefits. In some cases, the need for periodic adjustments is anticipated at the commencement of the CCA.

7.6.2.3 Balancing payments may also be required by tax authorities. A tax authority may make an adjustment to remedy an identified imbalance in contributions to the CCA relative to the participant's share of anticipated benefits. An adjustment may be required if a participant's contributions in the form of tangible assets, intangibles or services were under-valued. An adjustment may also be required when a participant's share of expected benefits is too low relative to its share of expected costs because the allocation key has failed as a proxy for expected benefits or when changes occur during the life of the CCA that would suggest the initial anticipated benefit shares have changed.

7.6.2.4 When such deficiencies are identified they may be remedied by a balancing payment. A tax authority examining a CCA and concluding that an adjustment is required may treat a participant as receiving a notional balancing payment which may result in a corresponding payment being made between the participants. Nevertheless, if a CCA has been established in good faith, tax administrations should be cautious in making adjustments, and only consider them when the participant's relative contributions are excessive compared to its share of the expected benefits over several income years rather than in one income year. When required, balancing payments should be calculated to ensure that each participant's share of the total contributions over the life of the CCA is consistent with that participant's share of the projected benefits over the useful life of the tangible assets and intangibles developed under the CCA.

7.6.3 Disregarding the CCA Terms

7.6.3.1 If an analysis of a CCA discloses that the terms of the CCA differ from the economic reality, a tax authority may disregard some of the terms of the CCA consistent with the determination of the accurately delineated transaction. In addition, section 3.3.2 is relevant as to the ability of tax authorities to disregard CCA arrangements in limited circumstances.

7.6.3.2 A tax authority may conclude that a participant is unlikely to benefit from a CCA or that any expected benefits would be trivial, especially if its contributions are significant. In this case, a tax authority may conclude that the arrangement fails to comply with the arm's length principle (since an independent enterprise would not participate in such an arrangement) and it may thus disregard the CCA.

7.7 CCA Entry, Withdrawal and Termination

7.7.1 General

7.7.1.1 At the time when a CCA is established, one or more participants may be required to make a payment for their share of tangible assets, intangibles or other contributions of pre-existing value made available to the CCA by other participants. Similarly, after a CCA is established, an associated enterprise entering the CCA as a new participant may be required to make a payment in return for acquiring an interest in the benefits that have been created under the CCA. A participant withdrawing from a CCA is required to receive a payment for its share of the value of the CCA. In addition, existing participants in a CCA may either increase or decrease their involvement in a CCA. These situations are considered below.

7.7.2 "Buy-in" Payments

7.7.2.1 When an associated enterprise joins a CCA, either at the commencement of the CCA or as a new participant after the CCA has been in operation, the associated enterprise may obtain an interest in contributions of pre-existing value made by other participants or in the realized benefits of the CCA created by such participants. This may include, for example, intangibles, other rights and work in progress. As the new participant acquires an interest in such benefits, the arm's length principle requires the participant to make an arm's length payment for this transfer from the other participants that created the pre-existing value. The sum payable for pre-existing benefits by a new participant on entering the CCA is called a "buy-in" payment.

7.7.2.2 The buy-in payment should be based on the arm's length value of the rights that the new participant is acquiring and its interest in the expected benefits of the CCA. If the work of a pre-existing CCA has been fruitless and a change in approach is being considered, there may be no buy-in payment as the new participant is not acquiring an interest in tangible assets or intangibles, rights or work-in-progress. The new participant may also be making a contribution to the CCA in the form of intangibles or other pre-existing tangible assets. The items being contributed would have to be valued under the arm's length principle and a balancing payment made to make up differences if the buy-in payment required is greater than the value of the items being contributed by the new participant. Alternatively, if the value of the intangibles exceeds the required buy-in amount, a balancing payment will be required from the existing participants to the new participant. This may involve a netting of the buy-in payment and the balancing adjustment.

7.7.2.3 The treatment of a buy-in payment for tax purposes should be determined under the domestic law and tax treaties of the participants' countries. The payment should be treated as a payment to an independent enterprise to acquire an interest in intangibles, rights and work in progress.

7.7.3 "Buy-out" Amounts

7.7.3.1 When a participant leaves a CCA a "buy-out" occurs in which the departing participant sells its interest in the tangible assets, intangibles and rights under the CCA to the remaining participants. The buy-out amount should be the arm's length value of the departing participant's interest in the CCA at the time the participant leaves the arrangement. In some cases, the CCA's efforts may not have resulted in any realized benefits and, consequently, the payment of consideration to the departing participant is unnecessary. The treatment of a buy-out payment for tax purposes should be determined under the domestic law and tax treaties of the participants' countries. The payment should be treated as a payment from an independent enterprise to acquire an interest in intangibles, rights and work in progress.

7.7.3.2 When new participants join a CCA, or when existing participants leave a CCA, an adjustment to the contributions of the continuing participants may be required to reflect the changes in their proportion of future anticipated benefits.

7.7.4 Termination of a CCA

7.7.4.1 On the termination of a CCA the participants must receive their respective shares in the tangible assets, intangibles and rights acquired and developed under the CCA. If a participant surrenders its entitlements under the CCA, the other participants would be required to make a payment, following the requirements for a buy-out set out above.

7.8 General CCA Requirements

7.8.1 CCAs should list the participants and their respective interests in order to minimize the risk of disputes over the ownership of the fruits of the CCA and disputes with tax authorities. Under a CCA the legal owner of tangible assets and intangibles may be one associated enterprise, but the CCA participants have joint interests in the tangible assets and intangibles. A feature of CCAs is that the participants must have an interest in the tangible assets, intangibles or benefit from the services that are the subject of the CCA. In the case of intangibles, a participant must be able to use its interest in the intangibles.

7.8.2 In general, CCAs between associated enterprises should meet the following requirements:[59]

- The participants would include only enterprises expected to derive mutual and proportionate benefits from the CCA activity itself (and not just from performing part or all of that activity);
- The arrangement would specify the nature and extent of each participant's interest in the results of the CCA activity, as well as its expected share of benefits;
- No payment other than the CCA contributions, appropriate balancing payments and buy-in payments would be made for the particular interest or rights in intangibles, tangible assets or services obtained through the CCA;
- The value of participants' contributions would be determined in accordance with the arm's length principle as elaborated in this Manual and, where necessary, balancing payments should be made to ensure the proportionate shares of contributions align with the proportionate shares of expected benefits from the arrangement;
- The arrangement may specify provision for balancing payments and/or changes in the allocation of contributions prospectively after a reasonable period of time to reflect material changes in proportionate shares of expected benefits among the participants; and

[59] OECD (2017). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.* Paris: OECD Publishing. Available from https://doi.org/10.1787/tpg-2017-en. See para. 8.50.

- Adjustments would be made as necessary (including the possibility of buy-in and buy-out payments) upon the entrance or withdrawal of a participant and upon termination of the CCA.

7.8.3 Participants in a CCA should prepare documentation on the nature of the CCA, the terms of the CCA, the expected benefits and compliance with the arm's length principle. The documentation should include information on:[60]

- The participants;
- Any other associated enterprises which will be involved;
- Any other associated enterprises that may be expected to benefit from the CCA;
- The activities of the CCA;
- The duration of the CCA;
- The measurement of the participants' shares of expected benefits;
- The contributions of each participant;
- The consequences of a participant entering the CCA, leaving the CCA or of termination of the CCA; and
- Balancing payments and adjustments to the terms of the CCA to reflect changes in economic circumstances of the participants.

7.8.4 In addition, participants are encouraged to monitor the operation of a CCA and:

- Record changes to the arrangement;
- Compare projections on expected benefits with realized benefits; and
- Record the annual expenditure of the participants to the CCA, the form of cash contribution and the valuation methods used, and the consistent application of accounting principles to the participants.

7.8.5 Example: Cross-provision of Services

Company A and Company B are members of a multinational group. Each company performs different services (Company A performs Service 1 and Company B performs Service 2), and Company A and Company B each "consume" both services (that is, Company A receives a benefit

[60] Ibid, see para. 8.52.

from Service 2, and Company B receives a benefit for Service 1).

Assume that the costs and value of the services are as follows:

Costs of providing Service 1 (cost incurred by Company A): 100 per unit

Market value of Service 1: 120 per unit. That is, the arm's length price that Company A would charge Company B for the provision of Service 1 is 120.

Costs of providing Service 2 (cost incurred by Company B): 100 per unit

Market value of Service 2: 105 per unit (note: assume that this is considered a low-value service)

In year one and in subsequent years, Company A provides 30 units of Service 1 to the group and Company B provides 20 units of Service 2 to the group. Company A and Company B enter into a CCA to share the costs and benefits of Service 1 and Service 2.

Under the CCA, the calculation of costs and benefits are as follows:

Cost to Company A of providing services:	3,000 (60% of total costs)
Cost to Company B of providing services:	2,000 (40% of total costs)
Total cost to group:	5,000
Contribution made by Company A (market value):	3,600 (63% of total contributions)
Contribution made by Company B (market value):	2,100 (37% of total contributions)
Total contributions made by group:	5,700

Company A consumes 15 units of Service 1 and 10 unit of Service 2. Company B consumes 15 unit of Service 1 and 10 unit of Service 2.

Benefit to Company A:

1,800 + 1,050 = 2,850 (50% of total value of 5,700)

Benefit to Company B:

1,800 + 1,050 = 2,850 (50% of total value of 5,700)

Contributions measured at value: Under the CCA, Company A should bear the costs associated with 50 per cent of the total value of contributions (5,700), or 2,850. The market value of Company A's in-kind contribution is 3,600. Company B should bear the costs associated with 50 per cent of the total value of contributions, or 2,850. The value of Company B's in-kind contribution is 2,100. Accordingly, Company B should make a balancing payment to Company A of 750.

It is difficult to distinguish between a CCA and intragroup services allocated through an allocation key. The following differences between CCAs and services arrangements within an MNE group have been identified:[61]

7.8.5.1 Example: EU report on differences between CCAs and service arrangements.

Table 7.T.2
Differences Between CCAs and Services Arrangements within an MNE Group

CCAs	Intragroup service arrangements
A CCA is an agreement to share costs, risks and benefits where the participants contribute cash, property or services.	Intragroup services are limited to the provision and acquisition of specific services within an MNE group.
The service provider and the recipients are all party to the one CCA.	The associated enterprise providing the services may enter into a separate agreement with each associated enterprise. This may result in the service provider having numerous bilateral agreements for the provision of intragroup services.
If a participant joins or leaves a CCA, a corresponding adjustment is required to be made on the contributions and the entitlements of each associated enterprise.	If an associated enterprise decides to expand a service arrangement or terminate the service arrangement, there is no effect on the other associated enterprises receiving the services.
A detailed written agreement containing the information set out in 7.8.3.	In some cases, written contracts may not be prepared.
The contributions of the participants are measured on a contribution basis.	The service recipient will be charged a service fee which will include a profit mark-up under the arm's length principle for the service provider.

[61] EC (2012). *Draft Report on Cost Contribution Arrangements on Services Not Creating Intangible Property (IP)*. Brussels: EC. Available from https://ec.europa.eu/taxation_customs/system/files/2016-09/2012-09_com516_en.pdf.

Table 7.T.2 (continued)

CCAs	**Intragroup service arrangements**
The allocation of costs under the arm's length principle must be based on each participant's expected benefits under the CCA.	The allocation key is designed as a proxy measure of the expected benefits that the recipient associated enterprise will receive from the services.

8 Transfer Pricing Aspects of Business Restructurings

8.1 Setting the Framework and Definition Issues

8.1.1 General

8.1.1.1 In recent years the tax aspects of business restructurings undertaken by multinational enterprises (MNEs) have attracted much attention from tax authorities globally. From a transfer pricing standpoint such reorganizations require consideration of how to apply the arm′s length principle to a cross-border redeployment of functions, assets and risks within the same MNE.

8.1.1.2 There is no legal or universally accepted definition of "business restructurings". In a transfer pricing scenario these are defined as the cross-border redeployment of functions, assets (tangible and/or intangible) and risks to which a profit/loss potential may be attached. In this respect business restructurings undertaken by MNEs should not be confused with the ordinary acquisition of a business or an ongoing concern. However, it may be common to undertake a business restructuring of the supply chain operations of an MNE following an acquisition, divestiture of a business, or in response to a changing business environment.

8.1.1.3 Common examples of business restructurings are reorganizations involving conversions of the manufacturing and/or distribution layer of an MNE such as (i) conversion of a buy-sell distributor into a sales agent or commissionaire or (ii) conversion of a fully-fledged manufacturer into a provider of manufacturing services (e.g. a contract or toll manufacturer). Business restructurings may also involve the transfer of the ownership and management of intangible property rights such as patents, trademarks, brand names etc.

8.1.1.4 As a general rule, businesses are entitled to organize their activities in the way they see fit. Business restructurings undertaken in a manner consistent with the arm's length principle are entirely appropriate. However, there may be situations in which business restructurings facilitate inappropriate income shifting through non-arm's length pricing or through commercially irrational structures. The guidance in this Manual, including this Chapter, applies to business restructurings to ensure that they are consistent with the arm's length principle.

8.1.1.5 The application of Article 9 of the UN Model Double Taxation Convention to business restructurings requires that the arm's length consideration for a supply, acquisition or transfer of property is that which might reasonably be expected to be made under an agreement between independent parties dealing at arm's length. As a result, a business restructuring generally involves the determination of whether at arm's length a payment would be warranted for the transfer of something of value, or for the termination or substantial renegotiation of commercial arrangements between associated enterprises, and if so what the amount of such arm's length consideration would be.

8.1.2 Business Restructurings: Considerations Regarding Developing Countries

8.1.2.1 The changes triggered by the implementation of a business restructuring can have significant effects on the allocation of profits (or losses) between the countries in which the entities of the MNE operate, regardless of whether or not tax savings are one of the motivations for the restructuring transaction. When an MNE changes its business model, the tax and legal structure of the group would generally require an alignment with the new business model.

8.1.2.2 Business restructurings increasingly affect developing countries. In recent years a number of large MNEs have either (i) transferred their manufacturing facilities into low-cost countries, e.g. where the cost of labour of a skilled workforce is lower and/or (ii) similarly moved certain distribution functions and/or (iii) similarly moved valuable intangibles out of the jurisdiction where they were acquired, developed or exploited. This Chapter discusses how to determine, on a case-by-case basis, whether or not the conditions of such restructurings comply with the arm's length principle.

8.1.2.3 In a business restructuring context, the arm's length principle entails a comparison of the conditions (including the pricing) of a transaction or arrangement between associated enterprises and those which would have been agreed between independent enterprises dealing at arm's length in similar circumstances. Where a particular transaction is a part of a broader arrangement in respect of a business restructuring, setting (as well as testing) the arm's length consideration for that transaction requires that all the circumstances relevant to the broader arrangement are taken into account in evaluating the comparability factors that might reasonably apply under an agreement between independent parties dealing at arm's length.

8.1.2.4 In the absence of reliable uncontrolled comparable data, an assessment has to be made of the consistency of the conditions of the controlled transaction with those that might reasonably be expected under an agreement between independent parties dealing at arm's length.

8.1.2.5 The above-mentioned process with respect to the implementation of the arm's length principle highlights the need for tax authorities in developing countries to be alert to business restructurings and their potential consequences. As already stated in other parts of this Manual, while it is for each country to determine its own tax system, the desire to avoid double taxation has been an important factor in the very broad acceptance of the arm's length principle internationally.

8.1.3 Process for Setting or Testing the Arm's Length Principle in a Business Restructuring

8.1.3.1 This part of the Chapter describes a typical process which may be followed when setting or reviewing transfer prices in the context of a business restructuring. This process is neither prescriptive nor exhaustive.

8.1.3.2 As a first step, it is important to characterize the transactions entered into by the associated enterprises, taking into account the business environment in which the MNE is operating. This entails carrying out the following activities:

- Identifying the **scope, type** (e.g. supply of goods, provision of services, licensing arrangements) **and economic nature of the arrangements** between the associated enterprises involved in the business restructuring;
- Performing a **functional analysis of the pre- and post-business restructuring activities of associated enterprises affected by the restructuring**. Such an analysis requires, as a starting point, reference to any relevant contracts, including those entered into to implement the business restructuring (e.g. contracts transferring the legal ownership of intangibles and those evidencing the terms and conditions of the pre- and post-restructuring arrangements for the business activities affected by the restructuring) as well as an examination of risks assumed and functions performed by the associated enterprises; and

- Examining the **consistency of the contractual terms with the outcome of the functional analysis** of the associated enterprises taking part in the business restructuring, in order to determine the true nature of the transactions, including the legal, economic and tax effects thereof. It should not be automatically assumed that the contracts, though they are the starting point of any transfer pricing analysis, accurately or comprehensively capture the actual commercial or financial relations between the parties. The core part of such an examination is the performance of a thorough functional analysis, which is needed to identify the value-adding activities and functions performed, assets employed and risks assumed in respect of the business activities affected by the restructuring.

8.1.3.3 The selection of the most appropriate method or methodologies applicable to the transaction(s) at stake follows from the functional analysis and the accurate delineation of those transactions. As discussed in more detail below, a business restructuring is commonly implemented through a series of intertwined transactions. For instance, a business restructuring might involve transferring functions, assets and risks to a tax favourable location. This should not of itself warrant the conclusion that a non-arm's length arrangement has been implemented.

8.1.3.4 Provided the pricing of the business restructuring itself and of the post-restructuring arrangements are consistent with what would occur under an agreement between independent parties in comparable circumstances the arm's length principle and its requirements are met.

8.1.3.5 For example, an associated enterprise may transfer the ownership of an intangible to its foreign principal and also agree to enter into a licensing agreement with that company that allows for the enterprise to continue to use the intangible in its ongoing business operations. In determining whether the transfer of ownership is consistent with the arm's length principle, taking into account that the transaction is part of a broader business restructuring arrangement, comparability needs to be assessed.

8.1.3.6 In practical terms, in many instances relevant third-party data are not available as the types of business restructurings commonly taking place tend to be unique to the various business models existing within MNEs. However, the lack of reliable third-party data should not lead the tax authorities to automatically conclude that the business restructuring as a whole does not comply with the arm's length principle. Where such reliable uncontrolled comparable data are lacking, the consideration that might reasonably be expected in similar circumstances may be determined by taking into account the following:

- ➢ An arm's length outcome is one that makes business sense taking into account the options realistically available for the taxpayer involved in the business restructuring;
- ➢ An independent party dealing at arm's length would seek to protect its economic interest involved in the arrangements, or be appropriately remunerated for forgoing such interest; and
- ➢ An independent party dealing at arm's length would compare the options realistically available in comparable transaction(s) and seek to leverage the overall value derived from the economic resources at its disposal. In certain cases, one realistically available option might be not to enter into a transaction in the event that it does not make commercial sense.

8.1.3.7 A key feature in understanding the underlying commercial rationale of a business restructuring is identifying the economic benefits expected from the restructuring. For purposes of this chapter, benefits expected at the MNE level from a business restructuring may be any form of economic or commercial advantage.

8.1.3.8 To this end, a business restructuring may be triggered as a response to changes in the business environment in which the associated enterprise involved is running its activities, such as competitive pressures, market conditions or changes in the regulatory environment. In the light of such changes an MNE may decide to restructure to reduce its losses or to retain or improve its profit-making ability and/or financial strength. That is, even if an MNE's overall profitability post-restructuring is less than its pre-restructuring profitability, such a restructuring might still be commercially rational in light of the MNE's realistic alternatives in the face of the changes in the business environment.

8.1.3.9 Business restructurings may include, or may be motivated by, outsourcing. Outsourcing occurs between independent enterprises, for example in relation to inventory management and logistics, IT support, after-sales support, customer receivables management and R&D activities. The underlying commercial rationale for a third party entering into an outsourcing agreement is that generally commercial advantages to the enterprise are expected from contracting out the activity, as compared with performing the activity itself. These expected commercial advantages may relate to cost reductions and/or retaining or increasing profits.

8.1.3.10 When restructuring, an MNE or one or more of the entities in the MNE may undertake a cost-benefit analysis. Should such an analysis exist and be documented (including any other financial and commercial data relevant to the restructuring) it may be helpful to determine the existence of the underlying commercial rationale triggering the restructuring.

8.1.3.11 An MNE may fragment functions across several MNE companies to achieve efficiencies by exerting group management coordination functions. For instance, it is quite common in restructuring the supply chain of highly integrated MNE groups to allocate functions such as logistics, warehousing, marketing and sales to different legal entities. As the functions generally represent the core of the supply chain of an MNE this may require coordination of activities at the group management level in order for the separate activities to interact effectively.

8.1.3.12 Accordingly, when conducting a functional and risk analysis of the controlled transactions between the associated enterprises carrying out the fragmented activities, the economic benefits to the MNE expected from the activities conducted separately should be identified within the context of the broader arrangements.

8.2 Types of Business Restructurings

8.2.1 General

8.2.1.1 Although the list below is not exhaustive, common types of restructuring carried out by MNEs involve:

- As concerns **manufacturing activities**, the conversion of fully-fledged manufacturers into contract or toll manufacturers (or vice versa);
- As regards **distribution activities**, the conversion of fully-fledged distributors into limited-risk distributors, sales agents or commissionaires (or vice versa); and
- As regards the **management of valuable, unique intellectual property rights**, the transfer of either trade or marketing intangibles to foreign intellectual property holding companies.

8.2.1.2 As a result, the restructured entity may end up performing limited routine functions, holding minimal assets, assuming limited risks and having a lower profit/loss potential attached to it. Profit/loss potential should be construed as “expected future profits or losses”. This notion is relevant in the valuation phase of determining an arm’s length compensation for a transfer of tangible and/or intangible assets or of an ongoing concern, or in the determination of an arm's length indemnification for the termination or substantial renegotiation of existing arrangements.

8.2.1.3 In another form of reorganization sometimes referred to as "reverse restructuring" a cross-border redeployment of functions, assets and risks may be directed towards highly taxed jurisdictions.

8.2.1.4 Taxpayers are generally free to arrange their business operations as they see fit but tax authorities have the right to verify consistency with the arm's length principle. Any restructuring as described above may be commercially rational. Disregarding or re-characterizing an arrangement entered into by an entity that is part of a multinational group should be the exception to the general rule of respecting the structuring as adopted by the taxpayer. See, however, 3.3.2 et seq. for a discussion of the recognition of the actual transaction.

8.2.1.5 Although a country may not have specific transfer pricing provisions dealing with cross-border restructurings, transactions entered into with the sole purpose of obtaining an undue tax saving could be challenged through the application of a general or a specific anti-avoidance rule (if present in the tax system of the jurisdiction concerned).

8.2.1.6 As a result, should either a domestic general or specific anti-avoidance rule be applicable to the restructuring, such rule may lead to the transaction as entered into by the taxpayer being disregarded. In such a case, there might not be room to apply any transfer pricing provision in order to set or test the arm's length conditions of the restructuring.

8.2.2 Transfer of Functions and Risks Arising from Business Restructurings

8.2.2.1 Business restructurings have to comply with the arm's length principle. This holds true both with respect to "exit scenarios" and "entry scenarios", i.e. irrespective of whether functions, assets and risks are transferred out of or into a jurisdiction.

8.2.2.2 To this end the following points warrant consideration:

- ➢ A key question is whether a transfer of functions, assets and/or risks conveys value and would be compensated at arm´s length. See Chapter 6 on intangibles in this respect; and
- ➢ Further, or alternatively, it may need to be determined whether the termination or substantial renegotiation of existing

arrangements would warrant indemnification at arm's length. The approach likely to be followed here is a two-pronged one, namely (i) an analysis of the underlying contractual arrangements so as to identify the content of any termination clause, and (ii) the determination of whether a third party would demand an indemnification in the event of a comparable termination or substantial renegotiation of contractual arrangements.

8.2.2.3 Some taxpayers have entered into business restructurings to contractually allocate economically significant risks to a group entity, perhaps located in a low-tax jurisdiction. Based on that risk allocation, economically significant risks (e.g. "key entrepreneurial risks") might purportedly be allocated to such an entity that would be presented as a "principal" contractually bearing those risks that justify the premium returns. It will be relevant to determine whether the principal has the capability to control, and actually controls, the economically significant risks allocated to it, and has the financial capacity to assume those risks, consistent with the attribution to it of a return for the risks. See the discussion of risk in Chapter 3 of this Manual, particularly at section 3.4.4.21 et seq.

8.2.2.4 For example, assume that Company A was a fully-fledged manufacturer of widgets which, among others, assumed economically significant inventory risk. During a business restructuring, Company B is set up as a principal. Under the new contractual arrangements between Company A and Company B the former is obliged to produce widgets according to the quality standards and production plan provided for by Company B. The contractual arrangements indicate that Company B is responsible for the inventory risk. However, the functional analysis shows that Company B does not in fact have any control over the inventory risk, i.e. it does not make the key decisions in relation to the production plan and has no influence over the deployment of risk mitigation strategies if, for instance, inventory levels rise because of a sales slow-down. Instead, these key decisions remain with Company A. In such a situation the accurate delineation of the transaction is such that the risk and associated consequences are appropriately assumed by Company A, i.e. the company actually controlling and managing the risk in spite of the terms of the contract allocating such risk to Company B.

8.2.3 Termination or Substantial Renegotiation of Existing Arrangements

8.2.3.1 In the case of a contract termination or substantial renegotiation, it should be determined whether an indemnity payment may be warranted under the arm's length principle. At arm's length, depending on the applicable commercial law of the country concerned, an indemnity payment may be warranted, for instance in the event a party withdraws from a contract in an unjustified and unforeseeable manner. Depending on the applicable commercial law, such an indemnification may, for instance, encompass the loss of future expected profitability. There is a wide variety of elements that may be taken into account by courts or other arbiters in determining whether an indemnification should be applied, for instance the nature and terms of the contractual arrangements, the circumstances of the termination or renegotiation and/or the economic dependence of one party on another.

8.2.3.2 Therefore, where a contract between associated enterprises includes a termination clause (and assuming the terms and conditions set out in it are in fact followed upon termination), it should be determined whether such terms and conditions are arm's length.

8.2.3.3 From a transfer pricing standpoint, another relevant factor relates to the opportunities the terminated party will be granted to obtain alternative business opportunities. That is, there may be a commercial counterpart to the business restructuring. This is specifically relevant as it is frequent in practice that in a group context the affected party having its contract terminated (or substantially renegotiated) will be entering into a different agreement with the same or another affiliate within the group. Tax administrations should examine the entirety of the commercial arrangements to determine whether or not a particular business restructuring transaction is at arm's length.

8.2.4 Example: Operational Considerations on the Transfer Pricing Aspects of a Business Restructuring

8.2.4.1 The following example illustrates the application of the approach to business restructurings as outlined above. The example summarizes the indicative issues which might arise in addressing the application of the arm's length principle to any specific business restructuring arrangement.

8.2.4.2 OpCo is a taxpayer resident in Country A operating a fully-fledged manufacturing and distribution activity of chemical components. Based on the contractual arrangements existing at the group level, OpCo has the following rights and responsibilities:

- ➢ OpCo oWwns or holds licensing rights over all the intangibles (such as patents, trademarks, and a legally protected specific "Just-in-Time" manufacturing planning know-how) that it needs to operate its manufacturing and distribution activities;

- OpCo is responsible for arranging the procurement of all raw materials (including selection of suppliers and qualification of raw materials);
- OpCo owns the inventories of raw materials, work-in-process and finished goods, assumes related inventory risk and actually performs the risk management and control functions;
- OpCo manages and controls the production planning, sets the output budget and determines the milestones within the supply chain process; and
- OpCo sells the finished goods to third-party customers in its market and to associated enterprises acting as distributors in foreign markets.

8.2.4.3 As far as financial results are concerned, OpCo has recorded relatively strong and stable profits over most of the past ten years, although they have been gradually declining over the past three years due to adverse global economic market conditions which triggered a steep increase in the input costs of production. The financial outlook for the next five years forecasts a continued decrease of profitability due to increased competition.

8.2.4.4 In the year 2000+X, the MNE of which OpCo is a member decides to enter into a restructuring of the supply chain manufacturing layer, by centralizing its management and control activities in a regional headquarters located in Country B and operated by the associated enterprise, Principal Co. The MNE's top management highlights during the shareholder meeting that the underlying commercial rationale for entering into the restructuring is to achieve forecast costs savings and efficiency gains allowing the group to achieve sustained profit growth over the following five financial years.

8.2.4.5 In particular, the business restructuring arrangement requires the implementation of the following steps:

- OpCo transfers to Principal Co. by means of an outright sale arrangement all the intangible rights that it owned in relation to the products. All the license agreements under which OpCo had rights over product intangibles (including the "Just-in-Time" know-how) are terminated as part of an arrangement whereby Principal Co. will enter into similar licensing agreements with the owners of these intangibles (i.e. Principal Co. is the new licensee);
- OpCo enters into a toll manufacturing agreement with Principal Co., whereby the latter company will have a sole ownership

interest and manage all the risks associated with the procurement of the raw materials and the inventory stock. Under the toll manufacturing agreement, OpCo will continue to use the rights related to the "Just-in-Time" manufacturing know-how on a royalty-free basis;

- Principal Co. is contractually responsible for the timing and quantity of the output to be produced by OpCo;
- Principal Co. has the right to dictate design specifications for the product, and to exert control over product quality;
- Principal Co. will pay a service fee for the manufacturing services provided by OpCo. The fee is calculated by adding a mark-up of ten per cent over the costs incurred by OpCo. Moreover, under the contract, OpCo does not bear any risk with respect to any potential profit or loss arising from the sale of the product (i.e. all the market and credit risk is purportedly shifted to Principal Co.) and has no role in determining the marketing strategy for the sale of the product;
- OpCo's distribution agreements with associated group distributors are terminated as part of an arrangement with Principal Co., whereby the latter company will enter into identical agreements with those same entities; and
- OpCo retains its distribution activity in its domestic market, for which it will now purchase finished products from Principal Co. (including products manufactured by OpCo in its toll manufacturing function).

8.3 Model Approach for Auditing Business Restructuring Issues

8.3.1 A suggested approach for a tax official of a developing country auditing this type of business restructuring would be to start from the transfer pricing documentation prepared by the taxpayer (see Chapter 12) and address the following questions:

- What is the accurate delineation, including the terms and effect, of the business restructuring arrangement and OpCo's related party transactions (in this case with Principal Co.) under that arrangement?
- What are the business strategies underlying the decision to enter into such a restructuring, including a high-level identification of the expected economic benefits?

- Do the functional analyses of OpCo and Principal Co., before and after the business restructuring is implemented, accord with the changes and any difference in the terms of the contractual arrangements?

8.3.2 Where the actual conduct of the parties does not reflect their contractual arrangements (for instance, because contrary to the contractual arrangements, OpCo's employees continue to manage production schedules, develop quality and design specifications and manage effectively the arrangements with the distribution affiliates), then the actual arrangements must be determined in order to accurately delineate the transaction and from there, select the most appropriate transfer pricing method in the circumstances of the case. See Chapter 4 on the selection of the most appropriate method.

8.3.3 Relevant comparable data in the above example may include: (i) similar uncontrolled arrangements involving a business restructuring with the conversion of a manufacturing entity into a toll manufacturer; (ii) similar uncontrolled transfer/sales agreements of patents and trademarks or similar intangibles (including rights in similar intangibles); (iii) the terms governing the termination of uncontrolled licensing and distribution agreements, similar to those in place in the pre-restructuring controlled agreements; and (iv) uncontrolled toll manufacturing arrangements similar to the post-restructuring controlled arrangements.

8.3.4 Depending upon the extent of such comparable data, any other available information relevant to determining whether the business restructuring makes commercial sense for both the transferor (OpCo) and the transferee (Principal Co.) should be obtained, taking into account the options realistically available to each of them at arm's length.

8.3.5 If reliable comparables cannot be identified, the tax authorities may still achieve an arm's length outcome by hypothesizing the conditions that might reasonably be expected to be agreed upon between independent enterprises dealing at arm's length in comparable circumstances.

8.3.6 Most notably, an important question to be addressed entails whether any compensation should be expected between OpCo and Principal Co. if a similar agreement had been entered into by independent enterprises dealing at arm's length in comparable circumstances.

8.3.7 This would entail, first of all, identifying the legal nature and economic value of the transfer of property between OpCo and Principal Co. (for example, patents, and trademarks, know-how or other intangibles, as well as tangible assets such as inventories) and, should the answer be affirmative, assessing whether an independent party might reasonably be expected to pay for it or to obtain compensation for supplying it.

8.3.8 Secondly, it would be necessary to investigate whether OpCo would, at arm's length, be owed an indemnification for the termination of its license agreements for the use of intangibles and distribution agreements, which resulted in a substantial renegotiation of its manufacturing status.

8.3.9 Thirdly, as an independent party, would OpCo realistically have the option of continuing to operate under its previous arrangements, or of undertaking a different restructuring? In particular, given all the legal, commercial, economic and financial circumstances, would OpCo as an independent party have any option realistically available other than to enter into the business restructuring on the agreed terms? For instance, would OpCo as an independent party legally have any option not to terminate its existing licensing and distribution agreements? Another related question is whether the conditions for termination of the licensing agreements with OpCo are arm's length.

8.3.10 Would Principal Co. as an independent party have any option realistically available to it other than to enter into the business restructuring on the agreed terms? Would Principal Co. have the option of entering into similar licensing, distribution and toll manufacturing arrangements without involving OpCo?

8.3.11 Moreover, does Principal Co. have both the decision-making capability and financial capacity to assume and manage the risks transferred to it by OpCo? Does Principal Co. actually perform such control functions in relation to its purported risks? Does Principal Co have the decision-making capability and financial capacity to assume and manage the risks associated with the ownership of the rights in the patents, trademarks and "Just-in-Time" manufacturing know-how? Does it actually perform such control functions in relation to these risks?

8.3.12 The answers to the above questions will inform the accurate delineation of the business restructuring. Assuming that the restructuring itself is not commercially irrational, arm's length pricing for both the restructuring itself (i.e. any transfers of value or indemnifications for the termination or substantial renegotiation of existing arrangements) and for the post-restructuring transactions should be able to be determined.

9 Intragroup Financial Transactions

9.1 Financing Arrangements Within MNEs

9.1.1 Financial transactions between independent enterprises are based on various commercial considerations. Members of an MNE, however, have the flexibility and discretion to decide the conditions that will apply to financial transactions within the group. As a result, in an intragroup situation, the tax consequences may be a consideration which has an influence on the nature or structure of those financial transactions.

9.1.2 Financial transactions are an important part of the operations of MNEs. Typically, financial transactions play a role in supporting the value creation process of MNEs. The responsibilities of corporate treasurers include managing cash to help MNEs meet their financial and business obligations and objectives. The aims of the corporate treasury function will include ensuring the availability of necessary cash flows, and will often extend to evaluating investment strategies to achieve an appropriate balance of risk and reward. Debt management is an integral part of their responsibility, as it is common for MNEs to finance part of their operations through loans. Similarly, the corporate treasury function may also manage the costs of external funding through the use of intragroup guarantees or through cash pooling arrangements. MNEs may operate on a decentralized basis with respect to their treasury management whereby each entity or group of entities within the group is responsible for its own financing arrangements; or it may instead centralize the treasury function at a regional or global level.

9.1.3 Intragroup financial transactions are subject to the arm's length principle just as intragroup services, intragroup sales of products and components, and other intragroup transactions are. As is the case in any other intragroup arrangement, the application of the arm's length principle to financial transactions first requires the accurate delineation of the actual transaction (see 3.3.2), including consideration of the purpose of the financial transaction in the context of the business of the MNE. Guidance on these matters is provided in section 9.6.

9.1.4 Regulated financial institutions like banks and insurance companies are governed by supervisory authorities, central banks and multinational banking institutions and require a license to operate. Such institutions are subject to a strict regulatory regime (Basel III rules) which may influence the intragroup financial transactions they can enter into. This chapter does not address transfer pricing of financial transactions conducted within a regulated financial institution. Instead, the discussion and guidance in this chapter are tailored to non-financial services MNEs that engage in intragroup financial transactions. The chapter does not attempt to cover the full range of financial transactions that may occur. However, as a general principle, the transfer pricing analysis of any intragroup financial transaction follows the same analytical framework as would apply to any other intragroup transaction. These are the principles laid out in Chapter 3 (Comparability Analysis), which describes the process by which the actual transaction can be accurately delineated and priced by reference to the arm's length principle.

9.1.5 Several factors combine to make intragroup financial arrangements important for both taxpayers and tax administrations:

- The significance (in terms of amounts involved and frequency) of these transactions for MNEs;
- The fact that money is mobile and fungible, which makes it relatively simple for an MNE to shift or locate debt in a particular MNE entity; and along with that debt, the ability to deduct associated interest. This can have the effect of reducing taxable profits of the borrowing entity, and can, depending on the situation of other MNE members, reduce the MNE overall tax liability;
- The difficulty that tax administrations may face in determining the true character and the specific features of certain intragroup financial instruments; and
- The concern that excessive interest deductions provide an opportunity for tax base erosion.

For the above reasons, many countries have introduced tax measures aimed at reducing the tax advantages of debt financing.

9.1.6 This chapter will introduce the transfer pricing considerations for intragroup financial transactions. First, it will describe the commercial considerations relating to corporate financing decisions. It will then present some of the more common types of intragroup financial transactions (section 9.3) as well as describing the operations of group financing departments/entities (section 9.4). The chapter goes on to describe various relevant corporate income tax approaches taken by tax administrations (section 9.5). Next, the chapter discusses the application of the arm's length principle to financial transactions in general (section 9.6 to 9.11), and finally, there are sections specifically covering intragroup loans (section 9.12) and intragroup financial guarantees (section 9.13).[63]

9.2 Corporate Financing Decisions

9.2.1 Corporate financing decisions are of fundamental relevance for an MNE. When an MNE identifies a business opportunity for which it requires funding, it will need to consider whether it should make use of internal funding (to the extent it is available) and /or external funding. Where external funding is used, consideration of the balance between equity financing and debt financing may also be required. Each has its own advantages and disadvantages that extend beyond tax considerations. Interest payments deriving from debt financing are generally deductible for the borrower (payer) and taxed as ordinary income in the hands of the lender (payee), whereas dividend payments, or other equity returns are generally not tax deductible to the payer and are often subject to some form of tax relief (exemption, credit, etc.) in the hands of the payee. It is beyond the scope of this Chapter to address the economic benefits or disadvantages of corporate financing decisions.

9.2.2 Although there are many theories that have attempted to hypothesize the relevant factors defining an optimal corporate capital structure, it should be noted that numerous factors influence the decision of a company's Management Board when defining the capital structure of their firm. Transfer pricing considerations do not serve to determine what capital structure is optimal for a company.

9.2.3 However, the capital structure of an entity that is a part of an MNE may impact the transfer pricing analysis of intragroup financial transactions. That is, to assess the impact of an entity's capital structure on intragroup financial transactions, it may be important to analyze the entity's debt capacity. This specific aspect is not discussed further in this Chapter. The commentary to Article 9 is relevant in this respect.

9.3 Common Types of Intragroup Financial Transactions

9.3.1 Many ordinary activities of an MNE require consideration of funding. These include: assuring cash flow for day-to-day operations, funding mergers or acquisitions, or making available credit facilities for operating companies seeking to purchase plant or equipment. Different financial instruments may

[63] This chapter does not discuss performance guarantees.

be utilized, depending on the amount of funding needed and length of time for which the funding is required. A wide range of instruments can be regarded as financial transactions. Typical examples include equity instruments (e.g. common stocks), debt instruments (e.g. ordinary and special bank loans, ordinary and special bonds, commercial paper and money market instruments, debentures, government securities), and financial derivatives (e.g., foreign exchange transactions, stock options, futures, forward contracts, notional principal contracts, investment derivatives and other hybrids).

9.3.2 In an intragroup context, more common financial transactions include intragroup loans, financial guarantees by a parent or group financing company for third-party loans to subsidiaries, cash pooling arrangements, hybrid financing, derivatives, and treasury services (e.g. foreign exchange risk management, factoring and forfeiting, netting arrangements, payment factories, commodity risk management, captive insurance, asset management, carbon trading, etc.). Intragroup loans and financial guarantees are discussed in more detail in sections 9.12 and 9.13, respectively.

9.3.3 Company treasurers are generally concerned with how to ensure MNEs have access to cash to meet their anticipated needs, to secure cost-effective financing, and to provide financial risk management appropriate to the level of risk the MNE wishes to assume. For example, if an MNE operates internationally, it is likely to receive payments in different currencies. For planning and budgeting purposes, different currencies present variability of future cash flows (usually at a cost). Entering into a forward contract can hedge (and effectively fix) future cash flows. Not hedging would leave the company exposed to currency fluctuations and to uncertainty as to the actual cash flows in the future. Group treasury functions may monitor these risks, evaluate any natural hedges that may exist within the MNE, and price hedging contracts where appropriate. Similarly, the need to buy inputs for production such as commodities that are subject to price fluctuations can cause substantial profit and loss volatility for a company. It is not always possible to enter into fixed price contracts for commodities; when it is possible, fixed price contracts may exclude the possibility to obtain further cost savings. The company's procurement and treasury departments may therefore work together to evaluate hedging arrangements. This chapter on financial transactions does not discuss hedging transactions.

9.3.4 In addition to management of cash flows, entering into intragroup loans or using revolving lines of credit, MNEs may also issue bonds or securities in the market to fund activities or to refinance existing loans. To make securities issued by the company more attractive to external investors, a parent company guarantee may be provided in support of the subsidiary that is the issuer of record. Similarly, a parent company may issue a guarantee to an independent bank that provides funds to a subsidiary company which has a low credit rating, in order to improve the terms and conditions of the subsidiary's bank loan (e.g. to reduce interest expenses). Intragroup financial guarantees come in many forms and are discussed in more detail in section 9.13.

9.3.5 Where an MNE has subsidiaries in different countries, the different parts of the business may be independently responsible for the cash management functions of each entity or group of entities. If these areas each act prudently, ensuring they have adequate cash, the group may, as a whole, end up holding more cash than they would have needed for operating purposes had they pooled their resources. Where these individual cash requirements are managed through a centralized treasury department which has a revolving credit facility with a third-party bank, the total amount drawn down will be greater than it would otherwise need to be. The MNE's treasurer may decide to implement a centralized cash pooling arrangement to net off the facility (i.e. a target-balancing or zero-balancing cash pool). This would reduce the cost of the credit facility (or avoid having to take out a loan for other needs) and make optimal use of the average cash balances sitting idle in the accounts of each area.

9.3.6 There are also cash pooling arrangements where a bank combines the debit and credit balances of different entities or departments of the MNE to derive net balances on a real or notional basis. As a result, interest is credited on a positive overall balance and debited on a negative overall balance (i.e. notional or interest compensation cash pool).

9.3.7 An intragroup cash pooling arrangement can generate numerous advantages for participants in the arrangement. These include minimizing the liquidity requirements, minimizing external interest costs, ensuring flexible day-to-day financing, reducing transaction costs related to local bank accounts, increasing the participants' bargaining power relative to external banks and thus helping them to obtain more advantageous conditions (e.g. interest rates) on the common bank account, and helping to centralize financing decisions. This chapter does not however discuss cash pooling transactions in further detail.

9.3.8 Another common type of intragroup financial transaction is captive insurance. An MNE may create an insurance company to provide coverage for participating MNE entities. Typically, the main purpose for doing so is to avoid using third-party insurance companies, which may have volatile pricing, or may not meet the specific needs of the company. By creating its own insurance company, the MNE may aim to stabilize premiums, reduce costs, cover difficult-to-insure risks, have direct access to reinsurance markets, and increase cash flow. When a company creates a captive insurer, it is indirectly able to evaluate the risks of subsidiaries, write policies, set premiums and ultimately either return unused funds in the form of profits, or invest them for future claim pay-outs. Captive insurance companies are also sometimes set up to insure the risks of the MNE's customers. This is an alternative form of risk management. This chapter on financial transactions does not discuss captive insurance transactions in any detail.

9.3.9 The scope of this chapter will be limited to the analysis of intragroup loans and intragroup financial guarantees, since they are the most commonly seen financial transactions in practice. However, the general guidance on these transactions may also be relevant to other types of financial transactions.

9.4 Common Types of Group Financing Departments / Entities

9.4.1 Financial transactions can be performed and organized in different ways within an MNE. The organization of the treasury function will depend on the structure of a given MNE and the complexity of its operations. Different treasury structures involve different degrees of centralization. In its most decentralized form, each entity within the MNE has full autonomy over its own financial resources. At the other end of the spectrum, a centralized treasury has full control over the financial resources of the entire group. That is, it centralizes some or all activities relating to cash and liquidity management, management of foreign exchange risk and interest rate risk, etc. In these situations, individual group members remain responsible for operational matters, while responsibility for financing matters is held by the central treasury. Centralization of financing and treasury functions can offer significant scale benefits and financing cost savings for an MNE.

9.4.2 There are several models of treasury departments/entities:

- Treasury departments/entities operating as cost centres: these treasury departments/entities operate essentially as service providers, assisting group companies with routine services, and arranging transactions on their behalf, but do not assume any risk of capital. Ensuring efficient use of cash and minimal financial volatility may be their main function;
- Treasury departments/entities operating as value-added centres: these treasury departments/entities operate as cost saving centres. They are more risk-tolerant than their cost centre

counterparts. They also focus on consolidating transactions and provide expertise to achieve net savings. To perform optimally, they need to be more centralized than pure cost centre treasury departments; and

- Treasury departments/entities operating as profit centres. Such departments/entities seek profits by actively creating market positions, as well as actively managing operational exposures. To be able to manage operational exposures they tend to be centralized in terms of structure and control of financial activities/ requirements. They may operate as in-house banks, maximize the profits of their own operations, and assume the risk of capital.

In practice, a combination of the profiles above is often seen.

9.4.3 The category of treasury department/entity that renders the specific financial transactions that are in place may be relevant and provide an initial indication of the most appropriate method to be used to assess the arm's length nature of intragroup financial transactions. To determine an arm's length remuneration for services rendered, an accurate delineation of the actual transaction (including a functional analysis) is required. See further Chapter 5 on Intragroup Services.

9.4.4 Treasury departments/entities operating as service centres are typically remunerated by applying the CUP Method, the CPM, or the TNMM based on cost. In contrast, treasury departments/entities operating as profit centres are typically remunerated based on pricing the transactions conducted and allocating the credit risk of those transactions to the treasury department. Consequently, it may be appropriate for the 'spread' between costs of funding and return on cash invested to be largely allocated to that treasury department/entity. To determine the arm's length remuneration for financial transactions such as loans and guarantees, reference is made to sections 9.12 and 9.13. It should also be remembered that the 'substance' of centralized activities generally requires careful review and is an important element of the accurate delineation process.

9.5 Corporate Income Tax Approaches Addressing MNE Financing Decisions

9.5.1 Raising corporate tax revenue can be especially important for developing countries. To the extent that a country's tax systems provide for income tax deductions for interest and not for dividends or other returns to equity capital, there is an economic incentive for companies doing business in those countries to use debt financing.

9.5.2 To reduce the base erosion effect of debt financing and the relevance of the tax factor in choosing between equity and debt financing, some countries have made the tax policy choice to introduce in their domestic tax laws measures aimed at either reducing the advantage of debt financing or increasing the advantages of equity financing. Measures which seek to limit base erosion associated with excessive debt financing can be broadly grouped into General Anti-Avoidance Rules (GAARs) and Specific Anti-Avoidance Rules (SAARs). For a more in-depth discussion on the specific available measures to counter excessive interest deductions claimed by residents, reference is made to the UN Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest and Other Financing Expenses.[64] The Practical Portfolio includes a discussion of the pros and cons of various measures[65] to counter excessive interest deductions.

9.5.3 Addressing base erosion through excessive interest deductions is a relevant issue for developing countries. However, choosing and implementing the rules requires careful and advance consideration of the possible tax policy consequences.

9.5.4 One common approach is to implement a rule that would limit net interest expense deductions based on their ratio to earnings before interest, taxes, depreciation and amortization (EBITDA).[66] Banks, insurance

[64] Prepared by Professor Brian J. Arnold, Canadian Tax Foundation, Toronto, Canada and Peter Barnes, Duke Center for International Development, USA.

[65] These measures may include transfer pricing rules, treating shareholder debt as equity, thin capitalization rules, earnings-stripping rules, preventing tax treaties from inhibiting the application of thin capitalization or earnings stripping rules, and other measures.

[66] As recommended by the OECD BEPS Action 4 Final Report. The following measures might complement this rule:

- Countries could adopt a "group ratio" rule to supplement the fixed ratio rule and provide additional flexibility for highly leveraged groups or industry sectors;
- Countries could adopt rules that allow interest expense as long as the entity's debt-to-equity ratio is not in excess of that of the worldwide group;
- Countries could allow for a carry-forward and carry-back with respect to disallowed interest expense or unused interest capacity;
- Countries could allow interest expense related to loans that fund public projects (such as infrastructure projects) and for entities with net interest expense that falls below a certain minimum threshold; and/or
- Countries could provide targeted rules for remaining BEPS practices in this respect.

companies and other financial businesses (leasing companies, asset management companies, companies subject to special tax regimes) might require special consideration under such regimes.[67] Another common approach is to implement thin capitalization rules which limit interest deductions by reference to a maximum allowable debt to equity ratio.

9.5.5 The interaction between the corporate income tax measures addressing financing decisions such as rules on thin capitalization and the transfer pricing rules might need careful consideration under domestic law, since both sets of rules might address similar issues and result in completely or partially denying deductions for interest and similar expenses.

9.6 The Application of the Arm's Length Principle to Financial Transactions (In General)

9.6.1 The assessment of the arm's length nature of an intragroup financial transaction essentially follows the same approach that applies for other intragroup transactions discussed in section 3.2. It requires the identification of the commercial or financial relations (including an understanding of the economically significant characteristics of the controlled transactions) leading to the accurate delineation and recognition of the actual transaction, and, after that, the selection and application of the most appropriate transfer pricing method. In this chapter, for practical purposes, references are often made to loan transactions since they are a common type of intragroup financial transaction. However, similar considerations apply to other types of intragroup financial transactions.

9.7 The Arm's Length Nature of Intragroup Financial Transactions

9.7.1 General

9.7.1.1 From a policy perspective the question regularly arises as to whether base erosion through excessive debt may be tackled through application of the arm's length principle. Article 9 of the UN Model Convention embodies the arm's length principle. The commentary to this Article references the OECD Commentary on Article 9, which in turn clarifies that the Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital. Based on the analysis in the

[67] As recommended by the OECD BEPS Action 4 Final Report.

UN Article 9 Commentary, (developing) countries have expressed the desire to use the concepts of Article 9 as embodied in their domestic transfer pricing rules for purposes of analyzing the arm's length nature of intragroup financial transactions and determining not only whether interest charges are excessive, but also whether the financial transaction is accurately delineated as debt. In this respect, reference is also made to paragraphs 3.1.4 to 3.1.9.

9.7.1.2 The decision to characterize a transaction that is presented as a loan (in its entirety or partly) as something other than a loan requires careful analysis and should be based on adequate information, as such a conclusion may lead to double taxation (see section 3.3.2.2). The approach taken to analyzing financial transactions is up to the tax authorities of the relevant jurisdiction, although it is recommended that they clarify which approach is routinely followed under their domestic transfer pricing rules and guidance.

9.7.1.3 Considering the above, the analysis of the arm's length nature of financial transactions can arguably be conducted from several perspectives. First, it could be undertaken by initially accepting the taxpayer's characterization of the transaction as a loan at face value, until the facts and circumstances of the transaction (including any additional available evidence or conduct of the parties) leads to a conclusion that the transaction is commercially irrational. If the latter conclusion is arrived at, the transaction may be disregarded as a loan for transfer pricing purposes. That conclusion does not necessarily affect the civil law or common law denomination of the transaction; it only affects the transfer pricing analysis. In this first scenario, the transaction essentially is treated as it is presented, until and unless it can be considered commercially irrational.

9.7.1.4 Alternatively, a second possibility is that the analysis of the financial transaction could be conducted from the perspective of determining whether the economically significant characteristics of the transaction lead to the conclusion that it sufficiently resembles and has the features or hallmarks of a loan, or alternatively, it more resembles something other than a loan. At a certain point, the review of the characteristics (together with the conduct of the parties or any additional evidence) may lead to the conclusion that the financial transaction is not a loan. If so, it may be that for transfer pricing purposes, the transaction ought to be treated as something other than a loan. This conclusion does not necessarily affect the civil law or common law denomination of the transaction, or its classification for accounting purposes; it only affects the transfer pricing analysis. Furthermore, if the facts and circumstances of the transaction lead to the conclusion that the transaction is commercially irrational, it may be disregarded as a loan for transfer pricing purposes.

9.7.1.5 A third possibility involves the same process as the second in terms of determining the characteristics of the financial transaction, however it also considers whether only part of the transaction should be treated as a loan. Relevant evidence might, for example, include a debt capacity analysis of the borrower. In such cases, it may be that for transfer pricing purposes the transaction is treated partly as a loan and partly as something other than a loan, such as a contribution to equity (see also the guidance at 3.1.8). Once again, this conclusion does not necessarily affect the civil law or common law characterization of the transaction or its classification for accounting purposes; it only affects the transfer pricing analysis. Furthermore, if the facts and circumstances of the transaction lead to the conclusion that the transaction as a whole is commercially irrational, the transaction may be disregarded as a loan for transfer pricing purposes.

9.7.1.6 Before deciding to question the nature of a financial transaction and split it into its component parts, tax authorities would be expected to have conducted a detailed analysis of the transactions and relevant associated enterprises. This may include consideration of the purpose to which they intend to put the borrowed funds, their economic circumstances, relevant business strategies, creditworthiness, debt capacity and security offered, etc. as outlined at 9.7.2.2 below. In all three scenarios mentioned above, the treatment of a transaction as something other than a loan would, for tax purposes, result in a limitation in the deductibility of interest expenses (entirely or partially) and not necessarily imply characterizing the transaction as something else (e.g. an equity instrument).

9.7.2 Economically Significant Characteristics of Financial Transactions

9.7.2.1 The following section provides an overview of economically significant characteristics of a financial transaction that may be considered when assessing such transactions for transfer pricing purposes.

9.7.2.2 Some of the economically significant characteristics of a financial transaction include the following:

- Contractual terms. Financial transactions between unrelated parties are usually documented in written terms and conditions set out in a contract. In contrast, the terms of a transaction between associated enterprises may be much less explicit. Where this is the case, other documents and information may need to be consulted to determine the terms and conditions of the financial transaction and whether the actual conduct of the parties is consistent with those terms and conditions. Relevant aspects generally contained in the contractual terms of a financial transaction include: [68]

a) the price for obtaining the financing, which generally is described as the interest to be paid where the financing is in the form of a loan. Interest may be fixed, floating or variable; payable annually, monthly, up front, upon repayment of the loan or on demand. Alternatively, the price could be determined based on a participation in profits or could be zero;
b) any repayment obligations and consequences of a failure to repay (default) by the recipient of the financing;
c) the term (time period) for which financing is provided. This may be short-term, long-term, fixed, undefined, perpetual, automatically renewable, eligible for periodic amendment or subject to the right to (make or demand) early repayment, in whole or in part;
d) whether the amount of financing extended is secured by collateral or a guarantee, or alternatively is unsecured. For loans, the existence of collateral or a guarantee may reduce the risk to the lender as they provide additional recourse for the recovery of funds should the borrower default;
e) the currency in which the funding is extended (and must be repaid);
f) the status (subordination or preferred status) of the provider of financing relative to others. Subordinated debt is debt that is ranked behind that held by secured lenders in terms of the order in which the amount outstanding is repaid should a borrower experience financial difficulties. That is, a creditor holding subordinated debt has a lower priority for the recovery of its debt from the debtor's assets than a creditor with a preferred status; and
g) convertibility of the funding, for example the right to convert the funding from debt into equity.

- Functional analysis: This analysis is relevant to determine what functions are performed, assets used or contributed and risks

[68] It should be noted that the listed contract clause examples are not exhaustive.

assumed by the respective parties (the provider and recipient of funds) in relation to the financial transaction. Facts and circumstances that may assist in determining the functions and responsibilities of the parties may include:

a) whether the recipient can obtain credit/funding from other sources (possibly including consideration of its debt capacity);
b) the (credit and other) risks of the provider in providing funding to the recipient;
c) who conducts the monitoring of ongoing compliance with the terms of the funding agreement;
d) for the recipient it could also include consideration of functions relating to ensuring availability of funds to repay the funding as required, i.e. considering the source of funds;
e) the intended and actual use of the funds provided to the recipient; and
f) it may also include considering the purpose of the financial transaction in the context of the parties' businesses; what assets may be used and what risks are assumed in relation to the financial transaction, including how those risks are controlled.

The above analysis should consider how those functions relate to the wider generation of value by the MNE to which the parties belong, the circumstances surrounding the transaction, and industry practices such as:

- Characteristics of the financial products or services: As already referenced at 9.3. supra and indicated under the contractual terms mentioned above, there exists a great variety of financial products or services. The characteristics of the specific financial transaction (or financial service) under review should be clearly defined and supported by the conduct of the parties and other facts in order to accurately delineate the actual transaction;
- Economic circumstances: Conditions (including the pricing) of financial transactions can vary greatly depending on the economic circumstances that apply when those financial transactions are entered into or take place. Aspects that may be relevant include: (a) the currency of the financial transaction; (b) the geographic jurisdictions of the parties to the financial transaction or the geographic jurisdictions that are captured by the terms of the financial transaction that are involved, (c) the specific business sector or industry in

which the parties to the transaction operate, and (d) the timing of the transaction. In addition, macro-economic trends and government policies may affect general interbank interest rates and other conditions and as such, may impact the cost of financial transactions; and

- ➢ Business strategies: An entity or MNE's financing policies may have an impact on how the financing transaction under review is structured. While accurately delineating the actual transaction, it will be helpful to have a clear understanding of the company's financing strategy as discussed in 9.2. The intent of the parties with respect to the funding provided, and any participation in management and voting power by the provider of the funds may be relevant considerations in this respect.

9.7.2.3 Determining the arm's length nature of a financial transaction requires that the perspectives of both parties to the transaction are considered. With respect to an intragroup loan, for example, this means that the economically relevant characteristics of the transaction should be analyzed from the perspective of both the lender and borrower. At arm's length, a lender will conduct a credit assessment of the borrower to make the decision on whether to provide a loan, as well as on the amount and the terms of the loan. A borrower will generally assess whether the term of the loan will meet its commercial needs and fall within its debt capacity. It will also need to have the capability to make decisions relating to the risks it is purported to assume.

9.7.2.4 The arm's length nature of a transaction should initially be considered by reference to the transaction actually undertaken by the associated enterprises as it has been structured by them. Tax administrations should examine the conduct of the parties and base the analysis of the financial transaction under review on the actual conduct of the parties. Based on domestic law or tax treaty considerations, it may be that the "label" applied to an intragroup financial transaction is not correct. Where this is the case, as discussed in 9.7.1 above, the arm's length principle may be applied to characterize an intragroup financial transaction as being different from that which was initially presented by the taxpayer.

9.7.2.5 Separately, it should be noted that in many jurisdictions there may be domestic jurisprudence on the above aspects as well, and this may impact on the nature of transactions involving funding. Domestic jurisprudence may be relevant or even determinative for the characterization of a financial transaction. However, in instances where the character of a financial transaction as debt or equity is not clear and where jurisprudence does not provide persuasive guidance, consideration of the relevant aspects mentioned in this chapter may be useful to the analysis of the transaction.

9.7.2.6 Once the financial transaction is accurately delineated, the most appropriate transfer pricing method can be selected and applied. Within this process, potentially comparable financial transactions can be identified, and comparability adjustments might be applicable, to determine the arm's length price or profit (or range of prices or profits) for the financial transaction(s) under review.

9.7.2.7 **Example 1: Accurate Delineation of the Actual Transaction (Provision of Funds)**

> Borrowing Company, BCo, receives funds under a loan agreement from Lending Company, LCo. BCo and LCo are associated enterprises. The loan agreement does not include a maturity date, no security is provided, and interest is contingent on specified levels of profits being achieved by BCo. While these features on their own should not be taken as indicating that the advance of funding is not a loan, on further examination of the facts, it is found that BCo uses the advance to fund the development of a new business concept, that its existing business is weakening, that both its existing and new businesses are not projected to be able to generate sufficient cashflows over a relevant period to service the loan, and that, consequently, lower amounts of interest will in fact be paid than provided for in the agreement.
>
> The guidance in section 9.7.1 is relevant to this example. Some features of the arrangement suggest hallmarks of equity rather than debt, and, together with the analysis of all the circumstances (e.g. BCo's businesses), may lead to a determination that for transfer pricing purposes the arrangement might not be delineated as a loan, with the result that interest deductions would be denied or restricted. Moreover, even if the arrangement is delineated on the evidence as a loan, the commercial rationality of the transaction might be questioned and may prevent determination of a mutually acceptable price. In particular, it is doubtful that BCo and a third-party lender would have been able to agree terms for a loan given the very high level of risk to the lender. This evidence may lead to the determination under the guidance of sections 3.3.2.1 to 3.3.2.6 that the loan arrangement might not be recognized as an interest-bearing loan for transfer pricing purposes.

9.7.2.8 Example 2: Accurate Delineation of the Actual Transaction (Loan Recognition)

AE Co 1 is organized in Country A where it maintains an office and has numerous employees. AE Co1 engages in a manufacturing business in Country A. It acquires raw materials from unrelated suppliers located in Country C. Before the events described below, raw materials purchased by AE Co1 were typically shipped from suppliers in Country C to AE Co1's manufacturing facilities in Country A via independent shipping companies.

After thorough review of alternatives, AE Co 1's management concludes that it could reduce its costs by commissioning the construction of a specially designed vessel and by using that vessel to meet its raw material shipping needs rather than relying on independent shipping companies to transport purchased raw materials. AE Co1 commissioned a design firm to prepare a unique vessel design suited to AE Co1's specific needs and identified an unrelated construction firm in Country C to build the vessel.

After the construction contract was negotiated by AE Co1 employees, but before it was executed, AE Co1 registered AE Co2 in Country C. AE Co1 contributed the minimum statutory capital under Country C law of $1,000 to AE Co2 in exchange for 100 of $10 par AE Co2 shares. AE Co 2 was to become the party contracting for the construction of the new vessel, and upon completion of the vessel would become the vessel's owner and the shipper of record for all of AE Co1's raw materials procured from suppliers in Country C.

Immediately after AE Co2 was registered, AE Co1 entered into a loan agreement with AE Co2 in which AE Co1 agreed to advance $100 million dollars to AE Co2 as required to (i) fund AE Co2's obligations to the construction firm under the construction contract and (ii) fund AE Co2's day-to-day operating expenses during the period the vessel was under construction. The loan agreement did not call for AE Co2 to make any periodic interest payments. The loan agreement provided AE Co1 with the option to convert the debt obligation to additional equity shares of AE Co2 at a conversion price of $10 per share at any time within five years. The agreement also permitted AE Co2 to retire the debt at any time within three years of the execution of the loan agreement in exchange for a payment of $105 million. AE Co1 advanced the $100 million loan amount entirely from its own internally generated funds. Funds were advanced to AE Co2 during the year following execution of the loan agreement as the funds were required by AE Co2 to make payments to the construction firm or for other operating expenses. AE Co1 did not borrow from any other party to finance the loan.

At the same time as the loan agreement was executed, AE Co2 signed the construction agreement. In conjunction with the execution of the construction agreement, AE Co1 executed a detailed written guarantee of AE Co2's obligations under the construction agreement in favour of the construction firm. The construction of the vessel was completed on schedule and the vessel was placed in service by AE Co2 one year after the loan agreement and construction agreement were signed. At the time it was placed in service, the vessel had a market value of $110 million.

At the end of Year 3, AE Co1 exercised its option to convert the entire loan principal to additional equity shares in AE Co2. AE Co2 never made any payment of principal or interest on the loan to AE Co1.

Countries A and C conducted a simultaneous audit of the tax returns of AE Co1 and AE Co2 for the three-year period following execution of the construction agreement and loan agreement. In the course of the audit, Country A tax authorities suggested that the $100 million advance should properly be characterized as a loan and that a transfer pricing adjustment should be made to attribute an arm's length rate of interest income to AE Co1 in each of the three years under audit. Country C tax authorities took the position that the advance should be accurately delineated for transfer pricing purposes as a contribution by AE Co 1 to the equity of AE Co2 from the outset and that no interest payments to AE Co1 should be imputed under transfer pricing rules.

In seeking to resolve the differences of view between the tax authorities of countries A and C, and in determining whether the advance of funds from AE Co1 to AE Co2 should be treated wholly or in part as interest-bearing for transfer pricing purposes, the answers to the following questions may help to illuminate some of the relevant considerations:

(i) are there features of the arrangements in their totality that suggest there were commercial pressures or legal requirements for the party to the construction contract to be located in the same territory as the construction firm, and that AE Co2 was created as the proxy in Country C for AE Co1 in order to fulfil these requirements?

(ii) are there features of the advance that indicate whether it has hallmarks of debt or equity? Relevant considerations might include the stated absence of interest requirements or repayment terms, the lack of interest payments, and the convertibility option. What evidence exists about the circumstances and motivation in Year 3 that resulted in conversion?

(iii) what is the debt capacity of AE Co2, that is, would a third party have provided a loan to AE Co2 in the circumstances described? Relevant matters might include the potential future cash flows arising to AE Co2 from its chartering of the vessel to AE Co1 upon completion that may be taken into account by third-party lenders, including the contractual rights to such cash flows; the length of the future period over which they may be expected to arise; the risk that they might not materialize; the potential for alternative chartering; and the risk that the completion date may be delayed (with the result that the cash flows are deferred). It may also be relevant to consider the security that may be taken into account by third-party lenders represented by the work in progress of the vessel at stages of construction as well as by its fully completed status. The special design of the vessel to meet the particular needs of AE Co1 may affect its perceived security valuation.

(iv) what are the risks of additional costs under the construction contract? AE Co1 has provided a guarantee to the construction firm, and this provides the construction firm with some protection against non-payment. However, the guarantee does not mean that, in an arm's length situation, AE Co1 would not seek to recover additional amounts from AE Co2, potentially leading to the need for AE Co2 to raise additional funds. The inability of AE Co2 to raise additional funds could increase the risk of default. Should risks of cost overruns be factored into the debt capacity of AE Co2, or is the construction contract a fixed price contract? Are potential delays in completion subject to penalties payable by the construction firm which would help to offset the delays in commencing chartering income?

(v) is it possible to compute a price for the loan that AE Co2 would reasonably be able to pay (taking into account its potential future cash flows) and that would properly remunerate AE Co1 for the risk it is taking on? The circumstances suggest that any standalone credit rating of AE Co2 would be below investment grade and that AE Co2 would present a significant credit risk. If not, is it possible to compute a price on the basis that part of the advance is treated as equity?

The guidance in section 9.7 is generally applicable to the considerations outlined above, and the guidance in section 9.7.1.2 is particularly relevant to this example.

9.8 Considering the Creditworthiness of Associated Enterprises

9.8.1 To accurately delineate the actual transaction and to be able to seek reliable comparables to test the arm's length nature of the intragroup financial transaction, the creditworthiness of the associated enterprises involved in the transactions may need to be considered. The creditworthiness of an enterprise has regard to the potential that the enterprise will not be able to meet its payment obligations in accordance with the terms of the transaction (in this respect mention is also made of "debtor" or "issuer" credit ratings, where the term "issuer" indicates the debtor). In the case of intragroup loans, this essentially involves, inter alia, consideration of the security of the lending (that is, what collateral the borrower can offer) and consideration of the borrower's likely future cash flows to pay interest and repay the principal amount of the debt. One way to assess debt capacity is to look at the credit rating of the debtor, which reflects the credit risk for a creditor extending debt to the debtor.

9.8.2 Credit risk may be measured by assigning a rating (i.e. credit rating) to the debtor or to a specific instrument issued by a debtor. In some cases, these ratings may be derived from independent commercial credit rating agencies. The rating expresses the probability of default and thus the risk to the potential lender. In addition to specialist credit rating agencies, some companies have also developed in-house commercial tools that are intended to be used for credit rating purposes. Credit ratings provided by independent credit rating agencies generally consider both qualitative and quantitative factors. Whereas credit rating methodologies used in in-house commercial tools generally prioritize quantitative factors and may not include qualitative factors such as industry forecasts, MNE strategies or the risk profile resulting from the MNE's management style.

9.8.3 Determining a credit rating is not an exact science and can be particularly difficult for certain types of issuers such as start-ups, special purpose vehicles, or indeed for members of an MNE. In the case of a credit rating determination for a member of an MNE, the financial metrics used in the process may be influenced by related party transactions.

9.8.4 A robust process for determining a credit rating will typically include consideration of both quantitative and qualitative factors. It is important to remember even amongst issuers with the same credit rating there is likely to be a range of creditworthiness represented. It should be considered that, while they can be useful, credit ratings are only an indication of an entity's probability of default and they may not be perfect. For example, in the 2009 financial crisis, some entities with high credit ratings defaulted on their debts and ended up bankrupt. Furthermore, in some developing countries the government may have official prescribed interest rates in place and no use is made of international commercial credit rating approaches.[69]

9.8.5 A summary of the credit rating categories used by the credit rating agencies Moody's, Standard and Poor's and Fitch is provided in the following table.

Table 9.T.1
Credit Ratings

Moody's	**S&P**	**Fitch**	**Interpretations**[a]
Investment Grade Ratings			
Aaa	AAA	AAA	Highest quality; extremely strong, highly unlikely to be affected by foreseeable events.
Aa1	AA+	AA+	Very high quality; capacity for repayment is not significantly vulnerable to foreseeable events.
Aa2	AA	AA	
Aa3	AA-	AA-	
A1	A+	A+	Strong payment capacity; more likely to be affected by changes in economic circumstances.
A2	A	A	
A3	A-	A-	
Baa1	BBB+	BBB+	Adequate payment capacity; a negative change in environment may affect capacity for repayment.
Baa2	BBB	BBB	
Baa3	BBB-	BBB-	
Below Investment Grade Ratings			
Ba1	BB+	BB+	Considered speculative with possibility of developing credit risks.
Ba2	BB	BB	
Ba3	BB-	BB-	
B1	B+	B+	Considered very speculative with significant credit risk.
B2	B	B	
B3	B-	B-	

[69] Reference can be made to credit rating rules that are applicable in Mexico and China.

Table 9.T.1 (continued)

Caa1	CCC+	CCC	Considered highly speculative with substantial credit risk.
Caa2	CCC	CCC	
Caa3	CCC-	CCC-	
Ca	CC	CC	May be in default or wildly speculative.
Ca	C	C	In bankruptcy or default.
C	D	DDD	

Source: Bhatia, A. V. (2002). *Sovereign Credit Ratings Methodology: An Evaluation. IMF Working Paper 02/170.* Washington: International Monetary Fund. Table 2, p.8

[a] Note that the interpretations provided in the column are only an indication and not a definition of the mentioned rating. The ratings provided are an illustration of long-term issuer rating/debtor ratings, from 3 public rating agencies. Ratings may be different for short-term debts.

9.8.6 When applying the arm's length principle, the starting point is that the related parties involved in the financial transaction should be treated as if they were entities independent of each other, but otherwise in the same circumstances. However, "the same circumstances" must include any incidental benefits and group synergies that derive from the fact that the related entities belong to an MNE. This would include the impact of any implicit support (sometimes also referred to as 'passive association', 'parental support', or 'group support'). To the extent that a borrower that is a member of an MNE benefits from an improved credit rating solely on the basis of implicit support, no payment is required for this benefit.

9.8.7 Credit ratings from independent professional rating agencies such as Standard & Poor's, Moody's or Fitch, are typically only available for the parent company of a group. Where no such independent credit rating is available for the borrower of the funds, consideration will therefore need to be given as to how to evaluate the credit risk of that borrower. The following approaches may be considered:[70]

- Beginning with the parent's credit risk, adjust this credit risk (if required) to approximate the credit risk of the borrower; and
- Derive the borrower's credit risk by using various credit scoring tools.

The effect of any implicit support available to the borrower would need to be

[70] There are additional approaches used in practice that may lead to an approximate credit rating for the borrower such as looking at third-party loans of the borrower as a basis for deriving the credit rating of the borrower.

factored into the analysis irrespective of the approach taken.

9.8.8 When assessing the credit rating of the associated enterprise and the extent of any implicit support that needs to be taken into account, consideration should be given to the specific circumstances, including (i) that the associated enterprise belongs to an MNE (which may have a higher credit rating than the enterprise) and (ii) that the parent or other group companies may be reasonably expected to support their affiliates (especially core affiliates) in their financial needs (referred to as 'stewardship by the parent company'). These factors may significantly influence the analysis of the arm's length conditions of the overall transaction. An improved credit rating for an associated enterprise based merely on implicit support or passive association does not require a return or payment at arm's length.

9.8.9 Expanding on the considerations of implicit support presented above, it might be relevant to consider the following questions:

- To what extent (if any) would implicit support be taken into account by independent institutions (e.g., independent lenders or credit agencies) when assessing the credit risk of the borrower?
- How would the implicit support be quantified?

9.8.10 In practice, the answers to the above questions will depend in large part on the level of strategic importance that the borrower has in the MNE (including the potential consequences of a default by the borrower on the rest of the MNE). In this regard, the following aspects could be considered:

- If the consequences of not supporting the borrower would create negative impacts on other parts of the group (for example due to legal obligations, operational impacts, effect on group reputation, etc.);
- If there are explicit statements of policy/intent by the parent/group to support the borrower;
- If there is a history of support to MNE entity borrowers in cases where they get into financial difficulty.

9.8.11 The following table is an example of the possible effects on the credit rating of an MNE entity borrower based on its level of strategic importance to the MNE:[71]

[71] Table 9.T.2 is based on Standard & Poor's (2019). *General Criteria: Group Rating Methodology.* Available from https://www.maalot.co.il/Publications/GMT20190702155208.PDF. Table 2 is merely an example for evaluating ratings and should not be regarded as prescriptive or definitive guidance. Note that implicit support may also be considered and determined based on quantitative data.

Table 9.T.2
Group Rating Approaches

Strategic importance of the borrower entity to the MNE	**Brief explanation of the strategic importance**	**Potential long-term credit rating of the borrower entity**
"Top down" approaches		
Core	Integral to the MNE's current identity and future strategy. The rest of the MNE is likely to support these entities under any foreseeable circumstance.	Generally equivalent to MNE level credit rating
Highly strategic	Almost integral to the MNE's current identity and future strategy. The rest of the MNE is likely to support these entities under almost all foreseeable circumstances.	Generally, one notch below MNE level credit rating
"Bottom-up" approaches		
Strategically important	Less integral to the MNE than highly strategic entities. The rest of the MNE is likely to provide additional liquidity, capital or risk transfer in most foreseeable circumstances. However, some factors raise doubts about the extent of MNE support.	Generally, three notches above the borrower entity's 'stand-alone' rating
Moderately strategic	Not important enough to warrant additional liquidity, capital or risk transfer support from the rest of the MNE in some foreseeable circumstances. Nevertheless, there is potential for some support from the MNE.	Generally, one notch above stand-alone rating
Non-strategic	No strategic importance to the MNE. These entities could be sold in the near to medium term.	Generally, the entity's stand-alone rating
[b] The 'stand-alone' credit rating for a member of the MNE as referred to in this table is the rating that would be derived for the borrower entity (e.g. using credit scoring models etc.) on the basis that it was not a member of an MNE, i.e. that it received no implicit support.		

It should be noted that implicit support is not equivalent to an explicit guarantee and is generally unenforceable by a creditor of the borrower. See 9.13 which deals with financial guarantees.

9.8.12 It is also important to note that although implicit support is typically associated with improving the credit rating of the borrower, it might also be the case that the borrower's credit rating is negatively influenced by the MNE's credit risk (i.e. as a result of negative synergies).

9.8.13 In addition to the credit rating of the borrower entity, for accurate delineation purposes the credit rating of the specific debt instrument is also relevant. See 9.12.[72]

9.8.14 Where there are significant difficulties in determining the extent and effect of any implicit support, and in cases where there is substantial information asymmetry, challenges may be created in the transfer pricing analysis which, if not resolved, may result in outcomes that are not reliable. In such cases, the credit rating of the MNE may also be used for pricing the accurately delineated loan where the facts so indicate, particularly in situations such as where the borrower entity is important to the group, and where the borrower's indicators of creditworthiness do not differ significantly from those of the MNE.

9.8.15 A further question arises as to whether the credit rating of the borrower entity should be established based on its creditworthiness before the financial transaction under review is put in place or afterwards. In most cases, the situation after the new financing transaction takes place should be considered.

9.8.16 In addition to the considerations above in determining the credit rating of a borrower entity it may also be relevant to consider the risk of an entity operating in a particularly risky country (i.e. the risk deriving from a country's business environment including legal environment, levels of corruption, and socioeconomic variables such as income disparity), to the extent that this is not already reflected in the credit rating of that entity. The country risk for developing countries tends to be higher than for developed countries due to greater perceived or real risk of currency fluctuations; political instability; economic instability such as recessions or higher inflation; the risk of default by the government on sovereign debt and the effect of foreign exchange and other controls. A high level of country risk will impact the business risk of a borrower located in that country and therefore also (likely decrease) its credit rating.

[72] For additional information on how to measure credit risk and how to consider credit risk components, reference is made to Petruzzi, R. (2013). *Transfer Pricing Aspects of Intra-group Financing.* Amsterdam: Kluwer Law International.

9.8.17 **Example 3: The Relevance of Implicit Support on a Borrower's Credit Rating**

A group entity's strategic importance might be impacted by facts such as whether it operates under the same commercial group identity as other MNE members or whether it is engaged in the same business as other MNE members. For example, assume an MNE named "ABC" is widely known and respected for its safe handling and transportation of cash and valuables, an activity it performs globally. The MNE is also financially strong.

Assume ABC has a subsidiary operating under the same global MNE identity (ABC Concordia Limited) that is associated with the safe handling of cash and valuables in Concordia. Due to Central Bank policies reducing the use of cash in Concordia, as well as a high level of organized crime in Concordia and the rise of competitor business in that country, the subsidiary's expected future profitability is low or even negative. ABC Concordia Limited has difficulty servicing a third-party loan and defaults on the loan. This default, if unresolved, may have a negative impact on the credit rating of the ABC group, because it may have been expected by third party lenders that the ABC parent company would have rescued its subsidiary that operates in the same business under the same MNE identity for fear of damaging the MNE's reputation and core business.

On the other hand, if the subsidiary had instead operated under a different group identity, XYZ Limited, and was engaged solely in the servicing of cash sorting machines, a minor and insignificant commercial activity that the ABC group does not perform in other markets, and was not engaged in the core business of picking up cash and valuables for safe transportation, the impact of a default might be less significant for the reputation or core business of the ABC group.

In these scenarios, the relevance and impact of implicit support is likely to be more significant in the case of ABC Concordia Limited and much more limited in the case of XYZ Limited.

9.9 Considering the Risks Embedded in the Financial Instrument

9.9.1 In addition to considering the creditworthiness of the borrower, in order to accurately delineate the actual transaction and to be able to seek reliable comparables, the specific features of the financial instrument must also be taken into account. For example, if ACo makes available a loan to associated enterprise BCo, but BCo already has three other loans (regardless of their sources), and the loan from ACo is subordinated to the earlier loans, then the "status" of the loan from ACo is lower than that of the other three loans. That is, if, in the event of BCo's bankruptcy, ACo is only entitled to claim repayment from BCo after the repayment of the other three loans, ACo holds a subordinated loan instrument with a higher risk. It may therefore be relevant to consider the credit rating for a specific financial instrument (e.g. a specific loan) and not just the credit rating of a borrower more generally.

9.9.2 Note that in the case of bonds (which are often used as comparables for intragroup loans) this risk "status" is generally expressed as the "issuance credit rating", that is the credit rating that applies to a particular bond issue rather than to an entity.

9.9.3 In practice, the credit rating of a particular financial instrument is generally notched down from the credit rating of the borrower entity, (usually) based on methodologies provided by credit rating agencies. That is, when comparables are sought for the financial instrument, first the credit rating of the borrower is considered, and subsequently the credit rating of the particular financial instrument is estimated by adjusting the credit rating of the borrower, taking into account the features of the instrument.

9.9.4 For example, assume that the credit rating of BCo is BBB, and the financial instrument provided by ACo to BCo is subordinated. Assume also that in line with the methodology provided by credit rating agencies, it is considered appropriate to apply a one-notch credit rating downgrade to reflect the subordinated nature of this financial instrument. Now, the credit rating of this financial instrument is BBB-, which is a one-notch credit rating downgrade based on the investment grade ratings (in this example of S&P and Fitch) presented in Table 9.T.1. Note however that different rating agencies have different approaches. While there is no universal approach, the effect of subordination merits consideration. See also 9.7.2.2.

9.10 Potential Transfer Pricing Methods

9.10.1 Any of the transfer pricing methods described in this Manual can be used to price financial transactions. With respect to intragroup loans, the most commonly used transfer pricing method is the CUP method. The CUP method may be employed when comparable transactions exist between one party to the intragroup loan transaction and an independent party ("internal comparable") or between two independent parties, neither of which is a party to the intragroup loan transaction ("external comparable"). This is discussed further in section 9.12.

9.10.2 Separate and apart from the pricing of individual financial transactions or instruments, treasury services provided within an MNE are likely to require an arm's length remuneration (see section 9.3.3). For these services, the CPM or a cost-based TNMM may be appropriate (or, if the treasury services entity is simply a conduit and adds no value, remuneration at cost). It is common that one entity of the group (e.g., the financing department/entity) acts as a general treasury service provider or intermediary for other entities in the group. See chapter 5 on intragroup services. However, if a financing department/entity provides financing to group members and refinances these with deposits from other group members or external sources and therefore is exposed to a mismatch in timing and/or currencies as well as credit risk exposure, the CPM might not be the appropriate transfer pricing method to reward the financing function.

9.10.3 Another method that could be appropriate in some cases is the transactional PSM. However, in practice, the use of this method for financial transactions is quite limited (some exceptions being for global trading of financial instruments or for certain cash pooling transactions).

9.11 The Use of Simplification Measures and Safe Harbours

9.11.1 To simplify the determination of the arm's length price for intragroup financial transactions, some countries have introduced safe harbours, most of which concern interest rates. More specifically, some countries issue annual official interest rates or margins that, if applied to intragroup loans, extinguish the obligation for the taxpayer to prove that the compensation related to those transactions is arm's length, while providing some assurance that the rate applied will not pose a significant risk of base erosion.[73] See also

[73] As an example, Singapore provides a safe-harbour rule for intragroup interest rates. The rule is based on a safe harbour interest rate margin above reference rates (e.g. LIBOR). The rule is rebuttable by taxpayers provided they substantiate their interest rate with proper economic analysis and transfer pricing documentation. In general, the indicative safe harbour interest rate margin is only applicable to related party loans below a certain amount (i.e. S$15 million at the time the loan is obtained or provided). The indicative margin is published on the tax authority website and updated at the beginning of each calendar year. For example, if the indicative margin is 250 basis points or bps (i.e. 2.50%), and the appropriate reference rate is LIBOR, this means that if a taxpayer uses LIBOR + 250 bps for its intragroup loans, it need not prepare TP documentation in relation to the loan. However, if a taxpayer chooses not to apply the safe-harbour rule, they must substantiate the interest rate used in line with the arm's length principle and maintain contemporaneous transfer pricing documentation. New Zealand has issued guidance for small value loans (of up to NZ$10 million principal in total) based on which taxpayers may apply a safe-harbour interest rate of 300 basis points (3%) on top of the relevant base indicator, in the absence of a readily available market rate for a debt instru-

section 9.12.2.8 on the application of “sixth method” approaches to intragroup loans.

9.11.2 Access to the credit rating of individual associated enterprises and the determination of the impact/effect of implicit support on intragroup financial transactions may be difficult and is often based on judgements or determinations that can be very hard to verify for tax administrations. Therefore, another possible simplification could be to use the MNE (or parent) credit rating as a basis if taxpayers do not provide evidence to substantiate the credit rating used. This approach has the added benefits of providing certainty and reducing the administrative burden to both tax administrations and taxpayers. See section 9.8.14.

9.11.3 When determining the arm’s length compensation for an intragroup financial transaction, the use of simplification measures or safe harbour rules should be carefully considered. Furthermore, it should be considered how the simplification or safe harbour interplays with the definition and application of the arm’s length principle both on a domestic and on an international level. In some countries, taxpayers maintain the right to rebut a safe harbour or simplification rule by demonstrating that an alternative amount is at arm’s length. In other countries, no such option exists. As regards to the use of safe harbours, reference can be made to sections 5.5 and 10.2.2.

9.12 The Application of The Arm’s Length Principle to Intragroup Loans

9.12.1 Different Types of Intragroup Loans and Relevant Characteristics to Consider

9.12.1.1 This section sets out a number of relevant characteristics of intragroup loans. An intragroup loan is the provision of financial resources from one related party (the lender) to another (the borrower) to be repaid at a later date. With an intragroup loan, the borrower will obtain the financial resources; the lender will generally assume the credit risk related to the loan and needs to be compensated for the liquidity provided and the risk taken on by an arm’s length interest payment. Ideally, the relevant terms and conditions of the loan will be specified in the loan agreement and supported by the conduct of the parties. If, and to the extent that an MNE has specific (explicit) group polices in place with respect to the (target) cost of financing, the likely impact thereof (if any) on the characteristic of a particular loan might also be considered relevant.

ment with similar terms and risk characteristics (this safe harbour rate relates to 2019 and its indicative value is revalued annually).

9.12.1.2 In practice, many different types of loans exist. Two examples are provided below:

- Term loan: a loan with a specified schedule for the payment of interest and the principal amount,[74] and a maturity ranging from one to ten plus years. Such loans are often used to fund medium- and long-term assets such as plant and equipment. A term loan may be secured or unsecured, carry a fixed interest rate or a floating interest rate, and contain general or specific performance covenants; and
- Revolving loan or revolving credit facility: a secured or unsecured credit line with a maturity ranging from six months to five plus years that a borrower can draw down and repay multiple times. A typical facility requires the borrower to pay the bank an annual commitment fee on the entire line in order to keep it available for future use; those without a fee are typically not committed and may be withdrawn by the bank at will. In some instances, banks require borrowers to repay the facility in full before allowing further draw-downs or renewals (a process known as a clean-up call).

9.12.1.3 Apart from the credit risk, the most common risks relevant to an intragroup loan will be interest rate risk, reinvestment risk, call/prepayment risk, inflation (or purchasing power) risk, liquidity risk, exchange rate (or currency) risk, volatility risk, political or legal risk, event risk, sector risk and country risk. During the accurate delineation process, the allocation of these risks will generally be considered. See Table 3.T.1 in section 3.4.4.6.

9.12.1.4 When analyzing an intragroup loan, relevant characteristics that may be considered include the following: conversion rights, currency, any applicable guarantees, timing and calculation of interest payments, options, repayment clauses, security provided, seniority and other terms of the loan. Loan characteristics that benefit the borrower generally have the effect of increasing the interest rate and those that have the impact of benefitting the lender tend to decrease the interest rate.

9.12.2 Determining the Arm's Length Nature of Intragroup Loans

9.12.2.1 In accordance with what was discussed in section 9.7, the first step

[74] A so-called "bullet loan" on the other hand allows for repayment of the principal amount only at the end of the loan term rather than through a specified repayment schedule.

of any transfer pricing analysis is the accurate delineation of the transaction undertaken. This requires the identification of the commercial or financial relations between the associated enterprises by analyzing the economically relevant characteristics (or comparability factors) of a transaction. Some examples of economically significant characteristics of loans include:

- The contractual terms of the loan (e.g., the type of loan; its tenor—i.e., time to maturity; the obligation to pay interest and repay principal including details of the repayment schedule (e.g. by way of a bullet payment at the end of the term or fixed amounts throughout the term of the loan); whether or not contingent; the type of interest rate (e.g. contingent on profits, variable or fixed); currency used; embedded options such as the right to convert the loan into equity, to extend its term, or prematurely terminate and repay the loan; seniority of the loan; subordination of the creditor relative to others; and any collateral, security or guarantees provided to the creditor. In some cases, certain relevant characteristics may not be included in the contractual agreement, and it may be necessary to refer to other evidence including the conduct of the parties to accurately delineate the terms of the loan;
- The functions performed, assets used or contributed, and risks assumed by both the borrower and the lender, considering the purpose of the loan and any interaction with other intragroup transactions. The functional analysis considers the perspectives of both borrower and lender and involves, for example, an assessment of the debt capacity and credit risk of the borrower. The conduct of the parties should also be examined. Where such conduct does not align with the contractual terms, the former may need to be prioritized;
- The economic circumstances of both the borrower and the lender in the context of the industries and markets in which they operate, including circumstances which have a bearing on the type of funding available, the purpose of the funding, and also the ability of the borrower to obtain loan financing/funding through other means or from other (third) parties; and
- The business strategies pursued by the borrower and lender, including financing policies and debt targets.

9.12.2.2 At this point, the accurate delineation process will have identified the economically significant features of the transaction. An accurately delineated loan transaction subsequently needs to be priced in accordance with the arm's length principle. The economically relevant characteristics that have been identified need to be taken into account in the search for comparable uncontrolled transactions with which to determine an arm's length price.

9.12.2.3 Once the transaction has been accurately delineated, the next step of the analysis would be the selection and application of the most appropriate transfer pricing method. As the main compensation generated by an intragroup loan is the interest payment, the arm's length interest must be determined. However, it should be considered that certain other elements might also be compensated separately (e.g. fees).

9.12.2.4 To determine an arm's length interest rate, the CUP Method is often applied. This means that reference is made to interest rates that are negotiated and agreed upon by independent entities for transactions comparable to the transaction under review. The CUP Method could be applied in the following ways:

- Internal CUP Method: interest rates which apply to similar transactions in similar circumstances between one of the tested parties and an unrelated entity;
- External CUP Method: either interest rates which apply to similar transactions in similar circumstances between unrelated entities or use of interest rates based on those published in public databases for similar debt instruments; or
- If simplification measures are in place, or an approach applies that is similar to the "sixth method" approach, the application thereof (see section 4.7).

9.12.2.5 When using an external CUP, the information deriving from third-party (syndicated) loans and bonds and other information contained in publicly available databases may be useful. Comparable uncontrolled interest rates for borrowers with a range of credit ratings can be accessed through databases made available by professional commercial data vendors.[75] These databases provide information on interest rates for arm's length loans and bonds with various conditions, including terms, currency, and timing (dates at which the loans or bonds are entered into), for borrowers of various credit ratings.

9.12.2.6 When applying the CUP Method, it is important that all the economically relevant characteristics that have a material effect on the interest rate are taken into account. Comparability adjustments may be needed to reflect such factors, where they can be made reliably.

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[75] Reference can be made for example to Bloomberg, Loan Connector, Thomson Reuters and S&P.

9.12.2.7 Apart from the CUP Method, as mentioned before, a cost-based method could be appropriate in some cases. One example could be in cases of on-lending whereby an MNE entity obtains funds from an unrelated entity and provides those funds to a related entity, i.e. "pass- through" scenarios. In essence, the intragroup loan is priced based on the cost of the funds to the lender, together with the expenses of arranging the loan and other relevant costs incurred in servicing the loan, a risk premium to reflect the various economic factors inherent in the proposed loan, plus a profit margin.[76] When applying this method, the lender's cost of funds relative to other lenders in the market may also need to be considered. A lender in a competitive market would seek to price at the lowest possible rate to win business. A borrower, likewise, would seek to borrow at the lowest rate available to it in the market. As with other methods, this method also requires consideration of options realistically available to the borrower, who would enter into this transaction only if there is no better alternative available.

9.12.2.8 Some countries apply a simplification rule for determining the interest rate for loans that resembles the "sixth method" that is discussed at 4.7 (in this regard, the relevant interest rate could be that for international public bonds such as US Treasury bonds, or the London Inter Bank Offered Rate (LIBOR) or even the interest rate of bonds issued by the country where the company making the loan is resident or where the loan is negotiated). These rates may work as proxies for interest rates of financial transactions between unrelated parties and may or may not be subject to appropriate adjustments for specific situations. The outcome of this approach provides a similar advantage as does the sixth method rule for commodities, that is to say it eliminates the need to search for a comparable transaction.[77]

9.12.2.9 Other relevant information in determining an arm's length interest rate for intragroup loans may include the use of Credit Default Swaps to reflect the credit risk linked to an underlying financial asset, or the use of economic modelling to price a loan by constructing an interest rate as a proxy to an arm's length interest rate.

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[76] OECD Publishing (2020). *Transfer Pricing Guidance on Financial Transactions*. Paris: OECD Publishing. Available from https://www.oecd.org/tax/beps/transfer-pricing-guidance-on-financial-transactions-inclusive-framework-on-beps-actions-4-8-10.pdf. See paras. 10.97 to 10.98.

[77] Brazil currently applies this methodology—see 1.8.4 of Part D of this Manual.

9.12.2.10 The arm's length pricing of intragroup loans may also involve the evaluation of related fees and other charges. It may need to be considered however, that associated enterprises may not incur charges similar to those that independent lenders (i.e. banks) would incur in the process of raising capital and satisfying regulatory requirements.

9.12.2.11 **Example 4: Accurate Delineation of the Actual Transaction (Loan Maturity)**

Borrowing Company, BCo, pays loan interest to Lending Company, LCo, in its 2019 financial period. BCo and LCo are associated enterprises. The loan agreement shows that the loan was made in January 2017 at a fixed interest rate of X% and specifies that the term of the loan is for a twelve-month period, at the end of which the principal is repayable. At the time the loan agreement is signed, based on BCo projected cash flows, it seems very unlikely that BCo will be able to repay the loan after twelve-months.

On further examination of the facts, it is found that BCo has expanded its business since January 2017, using the loan from LCo to purchase fixed assets. Since the principal was used to purchase fixed assets, a repayment of the principal could not be made. In addition, no repayment has been made under the terms of the loan, and BCo has continued to pay interest at X% on the loan in its 2018 and 2019 financial periods. BCo and LCo exchanged letters in January 2018 to confirm the extension of the loan for a further period of twelve months and repeated the exchange in January 2019.

The accurate delineation of the actual transaction determines that the loan is not in fact treated as a short-term loan of twelve months and should not be priced as a short-term loan but one with longer maturity. For pricing purposes, the maturity is at least three years, since the loan is by 2019 in its third year, or such longer period as might be evidenced by the purpose of the loan (in this case funding the purchase of fixed assets).

9.12.2.12 **Example 5: Accurate Delineation of the Actual Transaction (Currency of the Loan)**

Borrowing Company, BCo, pays loan interest to Lending Company, LCo. BCo and LCo are associated enterprises. The loan agreement specifies that the advance is denominated in currency X. On further examination of the facts, it is found that the advance was made in currency Y, and regular interest payments have been made in currency Y computed on the outstanding balance expressed in currency Y.

The accurate delineation of the actual transaction determines that the loan is treated as having been made in currency Y. For pricing purposes, the loan should be considered as a currency Y denominated loan when determining the appropriate interest rate.

9.12.2.13 **Example 6: Accurate Delineation of the Actual Transaction (Loan Security)**

Borrowing Company, BCo, pays loan interest to Lending Company, LCo, in its 2019 financial period. BCo and LCo are associated enterprises. The loan agreement shows that a loan of $5 million was advanced on 3 March 2019 at a fixed interest rate of 5% and specifies that the term of the loan is for ten years, at the end of which the principal is repayable. The loan agreement makes no reference to any security pledged by BCo to support the loan.

On further examination of the facts it is found that BCo is part of the MNE, XtraStore, that rents storage to customers. BCo owns storage premises, and on 3 March 2019 completed the purchase of two further premises for $6 million. At the same time, BCo repaid the outstanding principal of $1 million on a loan from a third-party bank. After repayment of the bank loan, BCo does not have any remaining third-party borrowings, and none of its assets are pledged in security.

LCo has several bank loans, all of which (apart from short-term facilities) are secured on its storage premises. Similarly, most other term loans of the MNE from banks are secured on the storage premises assets of the borrower entity. The previous bank loan that BCo repaid in March 2019 was secured on its assets held before that date.

The accurate delineation of the transaction determines that BCo took out the intragroup loan at the time it acquired new assets. Those assets are capable of providing security for the loan and are available to provide such security. The MNE, XtraStore, customarily uses its assets as security in arrangements with third-party banks, and BCo had also previously provided assets as security. For pricing purposes, the loan should be treated as supported by the security of assets owned by BCo in the absence of evidence that the commercial advantage of lower interest costs would be offset by potential commercial disadvantages in BCo pledging its assets in comparable uncontrolled arrangements.

9.12.2.14 The Internal Comparable Uncontrolled Price (CUP) Method for Intragroup Loans[78]

ACo, located in Country X, is an associated enterprise of BCo, located in Country Y. ACo and BCo conclude an intragroup loan agreement whereby ACo will provide financial resources to BCo.

BCo also receives financial resources from a third-party lender, with the same conditions as the ones agreed with ACo.[79] If the two loans are comparable (i.e. considering all the economically relevant characteristics), ACo and BCo could consider using the interest rate applied to BCo by the third-party lender to identify the arm's length intragroup interest rate. However, it should be noted that if the impact of the third-party loan is such that the credit rating of BCo would be relevantly reduced, the interest rate of this third-party loan may not present a proper internal CUP for the intragroup loan.

9.12.2.15 Example 8: The External Comparable Uncontrolled Price (CUP) Method for Intragroup Loans

ACo, located in Country X, is an associated enterprise of BCo, located in Country Y. ACo and BCo conclude an intragroup loan agreement whereby ACo will provide financial resources to BCo.

Publicly available information is available on the terms and conditions applied between third parties on comparable loans (i.e. considering all the economically relevant characteristics).

ACo and BCo could use the interest rates applied in the third-party comparable loans in order to identify the arm's length intragroup interest rate.

9.12.2.16 Example 9: The Alternative External Comparable Uncontrolled Price (CUP) Method for Intragroup Loans

ACo, located in Country X, is an associated enterprise of BCo, located in Country Y. ACo and BCo conclude an intragroup loan agreement

[78] Examples 7, 8 and 9 start from the assumption that, based on the accurate delineation of the actual transaction, the intragroup contracts are in line with the conduct of the parties. Therefore, the examples focus on the question of pricing the intragroup arrangement.

[79] One of the relevant assumptions is that the two loans received by BCo are *pari passu*. That is, both loans rank equally and neither is subordinated to the other.

whereby ACo will provide financial resources to BCo.

An arm's length interest rate could be based on the return of realistic alternative transactions with comparable economically relevant characteristics. Depending on the facts and circumstances, realistic alternatives to intragroup loans could be, for instance, bond issuances.

Publicly available information is available on the terms and conditions applied between third parties on comparable bonds (i.e. considering all the economically relevant characteristics).

ACo and BCo could use the interest rates applied in the third-party comparable bonds[80] in order to identify the arm's length intragroup interest rate.[81]

9.12.3 Interplay Between Intragroup Loans and Other Intragroup Transactions

9.12.3.1 The previous section discussed the pricing of intragroup loans, but the opening section of this guidance pointed out the importance of considering the interplay between intragroup loans and other intragroup transactions. This is because financing arrangements and the commercial purposes of funding can be a pointer in identifying the functions and economic circumstances of the MNE and in delineating other intragroup transactions for the transfer of property or services that may be supported by the financing arrangements. Even though the intragroup financial transaction under review may be accurately delineated and the interest rate for that separate intragroup financial transaction may be at arm's length, the existence of the intragroup financial transaction may point to economically significant characteristics of the associated enterprises that help to improve reliability of comparisons for the purposes of evaluating those other intragroup transactions.

9.12.3.2 **Example 10: Interplay Between Intragroup Loans and Other Intragroup Transactions**

Company A, a distributor in Country A and a member of MNE ABC, buys products from Company B, a related party producer in Country B. It markets those products in Country A and sells them to unrelated wholesalers and large retailers. Some of its largest customers are themselves

[80] In practice, the use of Yields to Maturity might be more appropriate.

[81] It should be considered that, in some situations, an illiquidity premium might be considered in order to account for the different liquidity between loans and bonds.

part of an international business with which MNE ABC does business in several countries. There are seasonal peaks for sales during the year.

Company A uses a TNMM as the most appropriate method to benchmark its distribution activities and to determine its compliance with transfer pricing rules. It uses the profit level indicator of operating profit (profit before interest and tax) to sales. It produces benchmarking studies in accordance with best practice to demonstrate that comparable companies achieve profit margins of 1%-3%, based on the interquartile range of results, not taking into account any working capital adjustments.

In Year 4 the results of the distributor continued to show an operating profit margin of 2% but its accounts included a significant increase in interest costs. These costs resulted in no profits being reported after interest.

In its transfer pricing documentation for Year 4, Company A explained that the interest related to a loan from Company C, an associated enterprise in Country C. Company A provided a report demonstrating that it had a high credit rating and that the interest rate charged was in line with interest rates charged to independent parties with a similar credit rating.

Upon review of the tax return of Company A for Year 4, the tax inspector was concerned about the intragroup interest costs which eliminated taxable profits. Something seemed amiss.

The tax inspector decided that further information about the loan was needed and determined the sole purpose of the intragroup funding was to finance the cost of extending more favourable credit terms to customers. The tax inspector further established that the distributor had extended credit terms to its customers from 30 days to 180 days, without changing the prices for its customers, but it continued to pay its related party supplier within 7-30 days in accordance with the MNE's centralized payment processing cycle. The changes responded in part to demands from the head offices of large (unrelated) international retailers who wished to expand their business with MNE ABC and standardize terms globally; and in part to enable smaller retailers in Country A to stock and display an extended range of products to stimulate demand.

In effect, Company A provided an incentive to its customers by taking on some of their working capital funding costs. This had the effect of significantly increasing Company A's working capital (in particular its accounts receivable). Unlike other kinds of sales incentives, however, the costs incurred by Company A (in the form of interest expenses paid to associates) are not included as part of its operating costs, and therefore, not considered as part of the operating profits used in calculating the operating profit margin.

The tax inspector concluded that there was no basis to question either the substance (e.g., through non-recognition) or the arm's length pricing of the funding arrangements considered in isolation. However, the funding pointed to an aspect of comparability, since the circumstances of Company A had changed when it extended its credit terms.

What needed to be examined was whether the TNMM benchmarking appropriately took into account all of the economically significant circumstances. In particular, working capital adjustments seemed appropriate to improve comparability in accordance with the guidance at section 3.5.3.7 et seq. They were applied by the tax inspector to adjust for the (higher) working capital of Company A compared to the comparable companies, effectively increasing the arm's length operating profits to account for the more generous credit terms that the loan (and the associated interest payments) allowed.

9.12.3.3 **Example 11: Interplay Between Intragroup Loans and Other Intragroup Transactions**

The facts are the same as Example 10, except that the tax inspector is not able to reliably apply the working capital adjustments, because the spikes in Company A's working capital due to seasonal peaks for sales occur in Q2 and Q3, and so are not reflected in the year-end balance sheets. Accordingly, the application of the TNMM could be reliably improved by comparing profits before tax rather than operating profits, since both Company A and the comparables are assumed to maximize profit through their collective commercial decisions about incentives, credit terms and funding costs, not all of which are reflected in operating profits.

It is important to note that the reliability of this approach may be reduced to the extent that the loan is not solely used to finance working capital. However, determining the purpose of the loan can help to improve reliability of comparisons under the TNMM. For example, a loan which is used to acquire fixed assets may indicate additional functions that affect the reliability of the benchmarking. A loan for such a purpose may also indicate changes in asset intensity. Diagnostic ratios may be applied to determine comparables with similar asset intensity to improve reliability in accordance with the guidance at section 3.5.2.34.

9.13 Application of The Arm's Length Principle to Intragroup Financial Guarantees

9.13.1 Different Types of Intragroup Financial Guarantees and Relevant Characteristics to Consider

9.13.1.1 With an intragroup financial guarantee, one related party (the guarantor) agrees to assume the financial obligations (deriving from the guaranteed instrument) of a related party (the guaranteed entity) towards a lender in the event that the guaranteed entity defaults on its obligations towards this lender. As a result, the risk exposure of the lender is generally reduced. With an intragroup financial guarantee, the guaranteed entity may be able to obtain more advantageous conditions (such as a lower interest rate) from the lender. However, it needs to be determined if the guarantor will provide the guarantee and assume the credit risk related to the guaranteed instrument in return for payment, i.e., a guarantee fee, and if so, the arm's length amount of that payment. Sometimes no guarantee fee will apply at arm's length. To determine the arm's length compensation for a financial guarantee (if any), the relevant terms and conditions of the guarantee, as well as the conduct of the parties should be considered.

9.13.1.2 Although the concept of financial guarantees may appear relatively straightforward, they merit closer review. Some financial guarantees can be structured or operate in extremely complex ways. To determine the arm's length remuneration for a financial guarantee, a closer look and accurate delineation will be a necessary step. In practice, many different types of intragroup financial guarantees exist, for example:

- ➢ Explicit credit guarantees: a legally binding commitment provided, in most cases, by a parent company to an MNE company which states that the former will pay to a third-party financing entity the amount outstanding in the event that the latter cannot fulfil its obligations. Three types of explicit guarantees are commonly used:
  - ➤ Downstream guarantees: a parent company issues a guarantee to external creditors for the benefit of one of its subsidiaries when that subsidiary enters into agreements with external creditors (typically used in decentralized business structures or when the location of the subsidiary is more attractive for obtaining external financing);
  - ➤ Upstream guarantees: a group company issues a guarantee to external creditors for the benefit of its parent company where the latter enters into agreements with the external creditors

(typically used when the external financing is obtained at a parent or holding level or when the parent company performs central treasury functions); and

- Cross guarantees: Several group companies issue guarantees to external creditors for the benefit of each other with the effect that they can all be considered as one single legal obligor (typically used in cash pooling).

9.13.1.3 Mention can also be made of comfort letters/letters of intent[82] and keep-well agreements,[83] but these generally do not transfer risk and generally are not considered as financial guarantees that require an arm's length payment.

9.13.1.4 A particular issue relating to intragroup financial guarantees is the concept of 'implicit support'. A lender may be willing to accept conditions for a loan to a borrower under the assumption that the borrower's parent company will step in and meet the obligations of the borrower if the latter fails to meet its obligations, without having received any legally binding confirmation from the parent company that it will do so. In such a case, the lender is merely assuming that there is a possibility that the parent company will take on the obligations of the borrower. Implicit support involves no explicit assumption of risk by the parent company deemed to be the 'guarantor' and no explicit right for the lender to ask the parent company to assume the obligations of the borrower in case the latter defaults. As such, implicit support itself does not constitute a financial guarantee. See 9.13.2.10.

9.13.1.5 An important issue in considering a financial guarantee is the extent to which there is implicit support, since implicit support usually has the result of reducing the cost of financing for the borrower. If there is no enforceable right for either the lender or the borrower to compel the parent company to assume the obligations of the borrower it can be expected that an independent borrower would not be willing to pay a guarantee fee (that is, the arm's length price would be zero). Nevertheless, simply by being a member of the MNE, the borrower may be able to obtain more favourable

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[82] These include a promise (generally not legally binding) provided, in most cases, by a parent company to an MNE company which states that the former will oversee the latter's affairs in order to be in accordance with the group strategies and rules, and refrain from taking adverse actions that would compromise the financial stability of another group company.

[83] These include a declaration provided, in most cases, by the parent company to an MNE company which states that the former will provide the latter with additional capital to prevent the risk of its default.

financing terms than it would have obtained on a stand-alone basis. The impact of implicit support is that the risk to the lender is perceived to be less than if the borrower were truly a stand-alone entity.

9.13.2 Determining the Arm's Length Nature of Intragroup Financial Guarantees

9.13.2.1 To determine the arm's length nature of (the fee for) an explicit financial guarantee, the following economically relevant characteristics (or comparability factors) should be considered:

- The contractual terms of the financial guarantee (including terms and conditions of the guaranteed instrument), as supported by the conduct of the parties;
- The risk profile of the borrower, after accounting for the impact of any implicit support, by considering the functions performed, and assets used or contributed (any available external credit rating of the borrower or of the guaranteed instrument and/or information on the probability of default of the borrower may be relevant in this regard);
- The risk profile and financial capacity of the guarantor;
- The characteristics of the financial guarantee (including benefits provided by the financial guarantee, if any);
- The economic circumstances of both the guarantor and the guaranteed entity and of the market(s) in which they operate; and
- The business strategies pursued by the guarantor and guaranteed entity.

9.13.2.2 The terms and conditions established in the financial guarantee, together with the conduct of the parties, need to be taken into account in accurately delineating the transaction that has been undertaken.

9.13.2.3 An assessment of the underlying reason for the financial guarantee and whether there is indeed any benefit created by it is required. Typically this will include an analysis of the form of the financial guarantee, its purpose, the willingness of the guarantor to provide support to the guaranteed entity, and any request by the lender to provide the financial guarantee, so that it is clear what obligations of the borrower (if any) are transferred to the guarantor and under what conditions.

9.13.2.4 An intragroup financial guarantee will have commercial value, and thus would require an arm's length fee if:

- Obligations of the borrower have been transferred to the guarantor under circumstances defined in the financial guarantee;
- The guaranteed entity/borrower achieves a better (lower) price for the intragroup loan because of the intragroup financial guarantee; and
- An independent party would be willing to pay for the guarantee in comparable circumstances.

9.13.2.5 In contrast, an intragroup financial guarantee fee is likely to be disallowed to the extent that:

- The guaranteed entity is perceived as having a better creditworthiness solely because of its group affiliation (so-called 'implicit support'), i.e. the financial guarantee does not improve the creditworthiness of the borrower beyond any benefits it already receives through implicit support;
- The debtor has no debt capacity or credit status and, therefore, would not be able to access the capital market without the financial guarantee. That is, a third party would never provide a loan to this debtor absent the guarantee, for example due to its insufficient debt capacity. In situations like this, an accurate delineation of the transaction might lead to the conclusion that the guarantee provided by the parent company is a function performed in its own interest and that the parent company, by providing the guarantee, essentially and substantively is the borrower; and[84]
- The financial guarantee has been requested by the creditor for the sole purpose of ensuring that the parent company does not divert the funds of the borrower, i.e., moral hazard issues (although in this situation there may be some benefit to the borrower to the extent it obtains a better credit rating).

9.13.2.6 The next step of the transfer pricing analysis would be the selection and application of the most appropriate transfer pricing method. The most common form of compensation for an intragroup financial guarantee is a guarantee fee. The arm's length guarantee fee could be determined by reference to guarantee fees that unrelated entities have agreed upon (or would agree upon) for similar transactions in similar circumstances. The following

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[84] E.g. the accurate delineation of the transaction could suggest that the transaction is not a guarantee arrangement at all, but that the purported guarantor is in fact the direct borrower.

factors may be relevant to the determination of an arm's length guarantee fee: the debtor's probability of default; the amount guaranteed; the guarantor's cost of capital (since it may need to set aside an amount as a contingency in the event the debtor defaults); and the benefit (if any) to the borrower as a result of the guarantee, after taking into account the impact of any implicit support. See 9.13.2.10.

9.13.2.7 The CUP Method may be appropriate, if comparable uncontrolled transactions in comparable circumstances can be identified. The CUP Method could be applied in the following ways:

- Internal CUP: based on guarantee fees applied to similar transactions in similar circumstances between one of the associated enterprises and an unrelated entity; and
- External CUP: This is more theoretical, as comparables are very hard to obtain. If available, they would consist of information on guarantee fees applied to similar transactions in similar circumstances between unrelated entities.

9.13.2.8 When applying the CUP Method, the information deriving from third-party financial guarantees (if available), bankers' acceptances, credit default swap fees, letter of credit fees, commitment fees, various types of insurance, and put options may be useful. Comparability adjustments may need to be considered where there are material differences in the economically relevant characteristics between the tested transaction and the potential comparables.

9.13.2.9 Other, more commonly used approaches to determine an arm's length guarantee fee include the following;

- Yield approach. This focuses on the benefit to the guaranteed entity. The yield approach tries to estimate the potential interest rate savings achieved by the borrower as a result of the explicit guarantee. It could therefore be used to determine the maximum guarantee fee a borrower might be willing to pay. It calculates the spread between the interest rate that would have been payable by the borrower without the guarantee and the interest rate actually payable. To determine the first element, the interest costs are calculated for the borrower as if it were to take on the loan without the explicit guarantee (but with implicit support). Reference can be made to section 9.7.2 in this respect. This is compared to the actual interest rate for the loan, i.e. with the benefit of the explicit guarantee. The difference of the saved interest is shared between the guarantor and borrower. Note that the guarantee fee cannot be 100% of this difference since the borrower otherwise would not receive any net benefit and so would not have any incentive to obtain the guarantee. The yield approach has been commonly accepted by various tax authorities and judicial bodies; and

- Cost approaches. These approaches focus on the cost to the guarantor of providing the guarantee. They could therefore be used to determine the minimum guarantee fee a guarantor might be willing to accept. Cost approaches quantify the additional risk borne by the guarantor or the value of the expected loss that the guarantor would incur by providing the guarantee. This could be determined by using one of the following approaches:
  - By considering the probability of default of the guaranteed entity together with the expected recovery rate in the event of a default;
  - By considering what capital is required to support the additional risks to the guarantor of providing the guarantee. This can be approximated provided careful consideration is applied, through: (i) a credit default swap model: the value of the guarantee is determined as a proxy of credit default swap fees; (ii) a contingent put option: the value of the price that the guaranteed entity should pay for a hypothetical right to sell the guaranteed instrument to the guarantor at a specified price (i.e., face value) and under certain circumstances (i.e., credit event) (otherwise stated, a put option on the guaranteed instrument); (iii) a cost of capital analysis: cost of additional equity capital that the guaranteed entity would hypothetically need to achieve the same level of creditworthiness as it has with the guarantee in place; (iv) considering financial guarantee insurance premiums; and.
  - It is worth noting that, in order to determine an arm's length guarantee fee, or an arm's length range of guarantee fees, the application of more than one approach is not a requirement.

9.13.2.10 **Example 12: Financial Guarantee and Implicit Support**

ACo, located in Country A, is the holding company of an MNE. ACo needs financial resources for the group's activities from external investors. For these purposes, ACo establishes a Special Purpose Vehicle (without control over risks), BCo, in Country B, whose exclusive function is the issuance of bonds, securities and other financial instruments into the market on behalf of the group. The group follows a common procedure consisting in using BCo as a mere intermediary financial entity to obtain funds in the capital market. This procedure, as a matter of process, has certain standard legal and contractual requirements, including a formal guarantee by ACo of the bonds or securities issued.

The market is made fully aware through the prospectus and other relevant materials that BCo is issuing bonds or securities on behalf of the group and, therefore, regards BCo as having the same creditworthiness as ACo. In this case, the effect of implicit support on BCo is such that the addition of explicit guarantee of the bonds or securities by ACo provides no additional benefits to BCo and as such, no guarantee fee should be payable.

It is appropriate to remunerate BCo for its role in issuing the bonds or securities on behalf of the group with a service fee.

9.13.2.11 **Example 13: The Internal Comparable Uncontrolled Price (CUP) Method for Intragroup Financial Guarantees** [85]

ACo, located in Country X, is an associated enterprise of BCo, located in Country Y. BCo has requested a loan from a third-party lender. ACo has provided an intragroup financial guarantee for this loan.

BCo also receives a guarantee on a different loan (having the same characteristics of the third-party loan guaranteed by ACo) from a third-party insurance company, under the same conditions as the ones agreed with ACo. Assuming that the intragroup financial guarantee and the third-party insurance are comparable (i.e. considering all the economically relevant characteristics), ACo and BCo could use the premium applied to BCo by the third-party insurance in order to identify the arm's length intragroup guarantee fee.

[85] Examples 13 and 14 start from the assumption that, based on the accurate delineation of the actual transaction, the intragroup contracts are in line with the conduct of the parties. Therefore, the examples focus on the question of pricing the intragroup arrangement.

9.13.2.12 **Example 14: The External Comparable Uncontrolled Price (CUP) Method for Intragroup Financial Guarantees**

ACo, located in Country X, is an associated enterprise of BCo, located in Country Y. BCo has requested a loan from a third-party lender. ACo has provided an intragroup financial guarantee for this loan.

Publicly available information is available on the terms and conditions applied between third parties on comparable financial guarantees (i.e. considering all the economically relevant characteristics).[86]

ACo and BCo could use the guarantee fees applied in the comparable uncontrolled financial guarantees to identify the arm's length intragroup guarantee fee.

9.13.2.13 **Example 15: The Yield Approach for Intragroup Financial Guarantees**[87]

ACo, located in Country X, is an associated enterprise of BCo, located in Country Y. BCo has requested a 5-year loan from a third-party lender. ACo provides an intragroup financial guarantee for this loan. The third-party lender provides the loan to BCo at an interest rate of 2%.

ACo's credit rating is A, while BCo's credit rating (after considering the effect of implicit support) is BBB.

Based on information available from public sources, a comparable uncontrolled loan (i.e. considering all the economically relevant characteristics, except for the intragroup financial guarantee) would have an interest rate of 3.25%.

Under the yield approach, the interest benefit received by BCo as a result of the guarantee (i.e. its reduced cost for the funding) amounts to 1.25% (i.e. 3.25% – 2%). Therefore, the arm's length maximum intragroup guarantee fee might be 1.25%. However, this amount might be reduced by considering how the advantage deriving from the guarantee should be shared between ACo and BCo.[88] The results of applying a cost approach

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[86] However, this kind of information may not be commonly available.

[87] Examples 15 and 16 start from the assumption that, based on the accurate delineation of the actual transaction, the intragroup contracts are in line with the conduct of the parties. Therefore, the examples focus on the question of pricing the intragroup arrangement.

[88] As a pragmatic approach, this advantage could be divided equally between ACo and BCo.

(see example 16) could be used to determine this split between ACo and BCo. Note however that there is no requirement to apply both the yield and cost approaches together to determine an arm's length guarantee fee.

9.13.2.14 **Example 16: The Cost Approach for Intragroup Financial Guarantees**

Facts are the same as in Example 15.

BCo's expected 5-year probability of default rate[89] is 1.44% and its expected recovery rate[90] (considering its fixed assets and securities) is 40%.

The cost approach quantifies the additional risk borne by the guarantor ACo by estimating the value of the expected loss that ACo may incur as a result of providing the guarantee, in the event BCo defaults (expected loss in case of default by BCo). The expected cost of providing this guarantee is 0.86% (calculated as follows: 1.44% × (1 – 40%)).

Therefore, the minimum arm's length guarantee fee might be 0.86%. However, this amount might be increased by considering how the advantage deriving from the guarantee should be shared between ACo and BCo.[91] The results of applying the yield approach (see example 15) could be used to determine this split between ACo and BCo. Note however that there is no requirement to apply both the yield and cost approaches together to determine an arm's length guarantee fee.

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[89] Probability of default is a financial term describing the likelihood of a default over a particular period. It provides an estimate of the likelihood that a borrower will be unable to meet its debt obligations during that period.

[90] Recovery rate is the extent to which the principal and accrued interest on defaulted debt can be recovered, expressed as a percentage of the face value.

[91] As a pragmatic approach, this advantage could be shared equally between ACo and BCo.

Part C

TRANSFER PRICING LEGISLATION DESIGN AND PRACTICAL IMPLEMENTATION OF A TRANSFER PRICING REGIME

10 General Legal Environment for Establishing and Updating Transfer Pricing Regimes

10.1 Introduction

10.1.1 Historical Development of Transfer Pricing Rules

10.1.1.1 Transfer pricing rules were introduced in domestic legislation by the United Kingdom in 1915 and by the United States in 1917. However, transfer pricing was not an issue of great concern until the late 1960s when international commercial transactions expanded greatly in volume. The development of transfer pricing legislation was historically led, in terms of implementation, by developed countries. In recent years, due to the growth and complexity of international "transfers" within MNEs, both developed and developing countries are introducing legislation to address transfer pricing issues.

10.1.1.2 Domestic transfer pricing legislation worldwide shows some harmonization in basic principles, in accordance with the arm's length standard, even if the application is not identical across jurisdictions. The introduction of transfer pricing rules has taken place within different legislative frameworks, and in the context of the sovereign right of countries to address taxation matters. The reasons why there has been increased consistency in approach include:

- ➢ The benefits of similar approaches between countries in terms of avoiding double taxation or double non-taxation;
- ➢ The broad acceptance of the arm's length principle as the best current alternative for dealing with transfer pricing issues; and
- ➢ The adoption by many countries of the UN or OECD forms of Article 9 in their bilateral tax treaties, so that they are already committed to the fundamental principle(s) set out thereunder.

10.1.1.3 With the increase in controversy regarding adjustments by tax authorities to transfer prices set by related entities, taxpayers increasingly seek practical dispute resolution mechanisms to avoid double taxation. As a result, the mutual agreement procedure (MAP) as set out in bilateral treaties[91] is evolving as a more effective mechanism through supplementary domestic regulations, as well as through increased practice regarding the management of the MAP.

10.1.1.4 Many countries have implemented advance pricing agreements (APAs) in their legal and/or administrative procedures as a bilateral dispute prevention / resolution mechanism to avoid double taxation. Other countries have introduced an arbitration procedure to give certainty that a dispute will be resolved. The advantages and disadvantages of these approaches are dealt with at Chapter 15; however, their application will be shaped by the legislative mechanisms of each country, and thus will take place in a variety of ways.

10.1.2 Key Considerations in the Design of a Transfer Pricing Regime

10.1.2.1 This chapter reviews the legal environment of transfer pricing legislation in a global context and seeks to identify the key practical issues from the perspective of developing countries. It should be emphasized that there is no "template" or model legislation that works in every situation. Transfer pricing legislation must be appropriate to the needs of a particular country. This means that any legislation of another country which is examined as a source of ideas should be considered closely as to why it has worked or has not worked in its original context. The ease of practical administration and the burdens of compliance with the rules of any model being considered should also be carefully analyzed. Those considerations and the "environment" of the legislation should be compared with those in the country introducing transfer pricing rules. This analysis will help indicate what notions or concepts, if any, the provisions are relevant to and adequate for, and how they could work effectively in the conditions of a particular country.

10.1.2.2 Drafters of transfer pricing legislation should take into account the outcomes of the BEPS Project, especially regarding Actions 8, 9, 10 and 13 (8 — Intangibles; 9 — Risks and capital; 10 — Other high-risk transactions, and 13 — Transfer pricing documentation and Country-by-Country reporting).[92] These issues are intended to have a more harmonized legal approach in a post-BEPS Project era.

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[91] Based upon Article 25 of both the UN and OECD Model Conventions.

[92] Reports available from http://www.oecd.org/tax/beps/beps-actions.htm.

10.1.2.3 This chapter also addresses the practical implementation of transfer pricing rules in a particular jurisdiction. As such, guidance is provided on:

- How the considerations and the substantive issues regarding legislative design can be implemented in a national transfer pricing regime through (substantive) laws and subsidiary regulations;
- How national transfer pricing regimes relate to other domestic tax laws;
- The position of transfer pricing rules in the overall framework of international tax rules within a particular domestic regime; and
- How to keep the newly implemented transfer pricing regime updated.

10.1.2.4 The rest of the chapters in Part C deal in greater depth with specific areas of implementation and administration. Chapter 11 sets out important considerations in establishing transfer pricing capability in developing countries. Chapter 12 covers the documentation requirements central to a transfer pricing regime, transparency issues and exchange of information, in an increasingly complex business environment. Chapter 13 provides a useful framework for risk assessment for transfer pricing purposes, and 14 discusses transfer pricing audits and provides guidance on approaches to managing audit programmes. Chapter 15 provides insights into approaches and techniques for dispute resolution, including how to access dispute resolution systems. Part C thus aims to provide a set of approaches by which a tax administration in a developing country can introduce and sustain a transfer pricing regime that meets international standards.

10.1.3 Domestic Transfer Pricing Legislation: Structural Overview

10.1.3.1 As already noted in Chapter 2, "transfer pricing" is essentially a neutral concept. However, the term is often used, incorrectly and in a pejorative sense, to mean the artificial shifting of taxable income from one company within an MNE to another company of the same MNE, in another jurisdiction, through incorrect transfer prices. The aim of such practices is to reduce the overall tax burden of the group. In such instances, the issue is the fact that the transfer price is not at arm's length. In this Manual "transfer mis-pricing" is used to denote instances when the transfer price set is not at arm's length. See section 2.1.1.6.

10.1.3.2 Many countries have introduced specific domestic tax rules to prevent possible tax base erosion through mispricing of transactions between related parties. As noted above, this legislation almost invariably requires that intragroup transactions are priced in accordance with the arm's length principle. The arm's length principle is generally accepted as the guiding principle for allocating income not only among related entities (MNE companies) but also among cross-border units of a single entity. Under the arm's length principle, it is generally necessary to conduct a comparability analysis of third-party transactions. However, where the taxpayer fails to provide the tax authority with the required information to enable a proper determination of an arm's length price in particular circumstances, some countries have adopted a presumptive taxation method (discussed at 10.1.9). Presumptive taxation is generally subject to rebuttal by the taxpayer, which may present counter-evidence to show that the results of the transaction are at arm's length.

10.1.3.3 Another approach to transfer pricing income allocation is referred to as global formulary apportionment (GFA). However, such a system cannot operate at a global level, in a way that fully avoids double taxation, without prior global agreement on a suitable uniform formula, which has not yet been achieved. This Manual addresses transfer pricing rules based on the arm's length principle. Virtually all developing countries accept the arm's length principle as part of their bilateral tax treaties and have adopted the arm's length principle as the basis for their domestic transfer pricing law. This Manual does not deal with the advantages and disadvantages, in the longer term, of other possible ways of dealing with transfer pricing, including GFA.

10.1.4 Key Considerations in the Design of a Transfer Pricing Regime

10.1.4.1 Some countries have formally recognized the guidance provided in this Manual in their domestic law. Even where this is not the case, the guidance in the Manual may provide useful reference for the application of the domestic legislation, unless there is inconsistency between the guidance in the Manual and the requirements of the domestic law.

10.1.4.2 An example of a country's legislation that recognizes the guidance in the Manual is Tanzania's Transfer Pricing Regulations of 2018 which provide that the Regulations are to be interpreted in a manner consistent with the arm's length principle in Article 9 of the UN Model Convention and the guidance in this Manual. The Regulations also provide that they are to be interpreted in a manner consistent with Article 9 of the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines.

10.1.4.3 Another example is Zimbabwe which enacted transfer pricing legislation in 2016. The provisions there formally recognize the Manual and the OECD Transfer Pricing Guidelines as guidance documents.

10.1.4.4 Two different broad approaches may be seen in domestic legislation relating to transfer pricing. Both of these approaches seek to implement an arm's length approach in relation to controlled transactions.

10.1.4.5 The first possible legislative approach simply authorizes the tax administration to distribute, apportion or allocate gross income, deductions, credits etc. when the tax administration determines that such distribution, apportionment or allocation is necessary in order to prevent tax avoidance or clearly reflect the income of any organizations, trades or businesses.[93] Under this system there is no reference to the taxpayer's compliance obligation in determining the arm's length price, while the arm's length principle may be stipulated in either the general primary legislation or within regulations or secondary legislation supporting the primary legislation.

10.1.4.6 The second legislative approach stipulates that, based on a self-assessment system, any foreign affiliated transaction shall be priced for tax purposes as if it had been conducted at arm's length.[94] In other words, a non-arm's length transaction is reconstructed as an arm's length transaction for the purposes of calculating taxable income and taxing such income. This legislative approach effectively requires taxpayers to conduct their initial tax accounting based on the arm's length principle.

10.1.4.7 A country's choice between these two approaches will depend on the basic principles of domestic tax law in that country. This will include issues such as the form of any applicable anti-avoidance legislation, time limits for application of the legislation, and where to place the burden of proof. However, the choice of styles of domestic legislation has generally made no substantial difference in the legal procedure of implementing the arm's length principle. The manner in which arm's length methodologies are stipulated in each country's legislation differs to some extent, as described below.

10.1.4.8 Depending on the legal system of the country concerned, tax laws may set out in great detail issues such as the definition of related parties, transfer pricing methodologies, documentation, penalties and the procedures for APAs. Other countries might opt only to identify the basic structure of tax base allocation among the related parties under the arm's length principle. In the latter case, detailed practical guidance will normally be available in subordinate legal materials, such as regulations, administrative rules and public notices. Even if such matters are defined in great detail in the primary tax law, there is a need to provide clear operational guidance.

[93] E.g. US Internal Revenue Code §482.

[94] E.g. Japan Special Taxation Measure Act §66-4(1).

Tax administrations should consider the level of guidance available in their countries and determine if further detail is needed.

10.1.4.9 There remains substantial risk of double taxation even when two countries follow the same arm's length principle approach. For example, double taxation may occur where specific guidance on the implementation of the arm's length principle is different from one country to another, and countries do not bridge this gap with any specific understanding or interpretative guidance. The following paragraphs demonstrate potential significant differences in domestic law which may result in major differences in how countries interpret or apply the arm's length principle.

10.1.5 Associated Enterprises

10.1.5.1 The definition of which persons (companies, trusts, individuals and other entities) and therefore transactions are covered by transfer pricing legislation is a key issue since the arm's length principle applies to transactions between related parties. Article 9 of both the UN and OECD Models considers enterprises to be "associated" (i.e. "related parties") if one of the enterprises meets the conditions of Article 9, Subparagraph 1(a) or 1(b) with respect to the other enterprise. These subparagraphs cover so-called parent-subsidiary relationships and brother-sister relationships.

10.1.5.2 The requirement of control in each subparagraph is satisfied if one entity "participate(s) directly or indirectly in the management, control or capital of [another] enterprise." There is no specific common guidance on this matter either in the Commentaries on Article 9 in the UN and OECD Models, or in the OECD Transfer Pricing Guidelines. This is mainly because transfer pricing issues are relevant only if special conditions have been made or imposed between two parties. Thus, the degree of control required to trigger the application of transfer pricing legislation has in effect been left to domestic legislation.

10.1.5.3 Some countries apply a 50 per cent shareholding threshold as the degree of participation required for "associated" status; some countries employ a lower threshold or place more reliance on other factors relating to de facto management or control. However, countries with higher thresholds usually employ substantive rules on control as a fallback, or subsidiary, test. These may focus on elements other than shareholding, such as dependency of input materials, distribution networks, voting rights, entities included in consolidated financial statements, financial resources and human resources in relation to other group members. Thus, there may be more commonality in country practice than would appear from a superficial comparison of shareholding thresholds.

10.1.5.4 Nevertheless, differing threshold criteria can result in disputes in certain circumstances. For example, if in Country A, the domestic law stipulates that a shareholding of 50 per cent or more is the threshold to qualify as an "associated enterprise", transactions between an entity owned 50/50 by two otherwise independent parties and one of its shareholders would be covered by the transfer pricing rules. However, if in Country B, the domestic law provided for a shareholding threshold of above 50%, the same transaction would not, *prima facie*, be subject to the transfer pricing rules in that jurisdiction.[95]

10.1.5.5 In South Africa, transfer pricing rules are applied to cross-border transactions between related persons, referred to under domestic law as "connected persons". A connected person is defined in relation to natural persons, trusts, members of partnerships and companies. Companies could be connected persons based on prescribed criteria if one of the companies holds at least 20 per cent of the equity shares or can exercise at least 20 per cent of the voting rights in the other company.

10.1.5.6 As an additional example, in Brazil, foreign companies and companies domiciled in Brazil are considered as associated companies when at least 10 per cent of the share capital in one (or both) of the companies is owned by the same individual or legal entity. The transfer pricing legislation also applies concepts of the Company Law to other situations to characterize two companies as associated or controlled companies. In fact, Brazilian transfer pricing legislation is very broad regarding the concept of "related persons", e.g. it also considers the kinship of an individual resident in a foreign country which has commercial relations with companies in Brazil that are controlled or managed by his or her relatives (depending on the kinship grade); and all transactions performed with listed jurisdictions (low-tax and non-cooperative jurisdictions) are deemed related persons.

10.1.5.7 For developing countries, an analysis of control might be an important element in ensuring that the transfer pricing rules can be administered effectively. In addition, factors for identifying control should be carefully examined because evaluation of those factors may require complicated fact-finding procedures, which might differ depending on industry sector, geographic characteristics, product cycle, etc.

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[95] An equal-footing arrangement is generally not understood to pose a high risk of income-shifting, although there could still be some room for non-arm's length pricing.

10.1.6 Coverage of Transactions, Availability/Priority of Transfer Pricing Methods and Compliance

10.1.6.1 Transfer pricing rules generally cover all cross-border intra-group transactions, regardless of whether participants are residents or non-residents for tax purposes. Thus, transactions conducted between a permanent establishment (PE) of a foreign company located in a jurisdiction and an affiliated company located in another jurisdiction are also subject to transfer pricing rules under the domestic law of that jurisdiction. In contrast, a transaction between a domestic PE of a foreign company and its affiliated company resident within the jurisdiction may not be subject to the transfer pricing rules in certain jurisdictions, such as Japan, because there is no substantial risk of income shifting beyond the legislating country's borders, see further 10.2.1.1.

10.1.6.2 However, transactions between local branch offices and their headquarters (and vice-versa) may be regulated by specific legislation, such as the non-resident/foreign company taxation rules, and consequently be affected by Article 7 of tax treaties (usually based upon the UN or OECD Models). Although under such circumstances the arm's length principle generally prevails, the legal framework of taxation could be different. For example, the dispute resolution mechanism might be different depending on each country's domestic law and the relevant treaty regarding this type of transactions. Nevertheless, in general, the same domestic transfer pricing legislation may be applicable both to transactions between a local branch (PE) and its headquarters (see Article 7 of the UN and OECD Models), and to transactions between associated enterprises (see Article 9 of the UN and OECD Models), even though a tax treaty may exist between the countries involved in the transaction.

10.1.6.3 The availability of different types of transfer pricing methods, the choice of method and the priority to be given to various different transfer pricing methods are matters often covered by domestic legislation. This is often done through administrative guidance or other subsidiary materials instead of taxation laws. Many countries have followed the OECD Transfer Pricing Guidelines, and/or this Manual in developing their domestic legislative frameworks, and have adopted the traditional transaction methods as well as the transactional profit methods when establishing whether a transfer price was at arm's length. See Chapter 4 for detailed discussion of transfer pricing methods.

10.1.6.4 Ease of administration is another important issue in the design of legal frameworks. Documentation requirements supported by penalties or other deterrents against non-compliance are the main instruments used by tax authorities for collection of sufficient information to test whether or not taxpayers have established an arm's length result. Transfer pricing documentation is a significant compliance cost for MNEs, especially where there are differences in countries' requirements. There is value in seeking to align documentation requirements with those of other countries, unless there are good reasons in terms of reducing compliance and collection costs, or specific features of local legislation, that require differences. Action 13 of the OECD/G20 BEPS Project specifically focused on transfer pricing documentation and Country-by-Country reporting, and guidance has been published on the implementation of relevant measures.[96] See Chapter 12 for guidance on transfer pricing documentation and Country-by-Country reporting.

10.1.6.5 Some differences in the coverage of transactions or in the legal form (statutes with penalty provisions or administrative guidance on self-assessment) will remain. It is therefore appropriate to continuously evaluate documentation and penalty legislation for effectiveness and proportionality. The experience of countries that have introduced transfer pricing rules may be helpful to developing countries just starting to introduce transfer pricing legislation.

10.1.7 Insufficient Information

10.1.7.1 A critical issue for developing countries as well as developed countries when applying any methodology will often be the lack of third-party comparables, particularly comparables from the domestic market. As this Manual has shown, however, in many cases it may be the case that foreign comparables will be appropriate for the transfer pricing case at hand. Where this is not the case, for instance where it is found that the most appropriate method involves a local tested party and there are particularities in relation to the domestic market that mean foreign comparables are unlikely to be reliable, practical guidance in applying the arm's length principle and the transfer pricing rules without sufficient domestic information on independent comparables should be a key focus in domestic legislative frameworks. This Manual as a whole is intended to assist especially in this area; users should

[96] OECD (2015). *OECD/G20 Base Erosion and Profit Shifting Project: Transfer Pricing Documentation and Country-by-Country Reporting: Action 13.* Paris: OECD Publishing. Available from https://www.oecd.org/ctp/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report-9789264241480-en.htm. Further guidance that was issued is available from https://www.oecd.org/tax/beps/guidance-on-country-by-country-reporting-beps-action-13.htm

refer to Chapter 3 on Comparability Analysis in particular. Domestic legislative frameworks and administrative guidelines should generally address the analysis of comparables as a benchmark of the arm's length principle. Such frameworks should seek to establish useful and effective guidance on matters such as comparability analysis (use of foreign data, adjustment of differences, profit split etc.), access to data, safe harbour rules, if any, and burden of proof. It is worth paying attention to the sixth method outlined in section 4.7 (Chapter 4).

10.1.7.2 In addition, the PCT Transfer Pricing Toolkit (see 2.5.3.2) contains a number of useful suggestions that could be considered in cases where there is a systemic problem involving a lack of comparables. For example, the toolkit:

- Suggests ways in which government agencies can increase the pool of available comparables data, for example, by instituting requirements to publish audited financial statements;
- Recommends focusing on risk assessment approaches that consider the arm's length nature of related party transactions, so as to ensure scarce audit resources are concentrated on cases most likely to yield results;
- Suggests consideration of safe harbours (see 10.2.2), fixed margins or other prescriptive approaches (see 10.1.9);
- Discusses the application of the PSM and the use of valuation techniques which do not directly rely on comparables data, where it is found that such approaches constitute the most appropriate means of determining arm's length prices or profits;
- Suggests consideration of cooperative compliance approaches in appropriate cases as a means of helping tax administrations to access industry information which may otherwise be difficult to obtain; and
- Suggests the use of anti-avoidance measures as a backstop to the transfer pricing rules in the most egregious cases, or those where there is a high risk of systemic abuse.

10.1.8 Burden of Proof

10.1.8.1 The burden of proof in tax litigation refers to the need to affirmatively prove the truth of facts alleged by a litigant based on a preponderance of evidence. It is also sometimes referred to as "the risk of non-persuasion" or the "burden of persuasion". A litigating party meets this burden by convincing the fact-finder to understand the facts as proposed by that party.

The party with this burden stands to lose if its evidence fails to convince the judge during a trial. A concept that precedes, but is different from, the burden of proof is "the burden of allegation", which means a party's duty to plead a matter in order for that matter to be heard in the lawsuit. A litigant who brings a suit needs to satisfy both the burden of allegation and the burden of proof to win a lawsuit.

10.1.8.2 The burden of proof operates in litigation. However, it is important to be able to consider which party has the burden of proof during a tax audit exercise or when transfer pricing assessments are made because the case may ultimately end up in court.

10.1.8.3 The burden of proof for transfer pricing litigation may be determined in accordance with the burden of proof rules of civil procedure or tax litigation in general in the relevant jurisdiction. If there are many court decisions on transfer pricing, the burden of proof for transfer pricing cases may be formulated in more detail through those precedents, depending on the general status of precedent in a given jurisdiction. The burden of proof rules for transfer pricing cases differ among countries.

10.1.8.4 In several countries the burden of proof rests originally on the taxpayer, as they are obliged to prepare, maintain and present documentation demonstrating that the terms and conditions of their related-party transactions are consistent with the arm's length principle. The position that the taxpayer bears the burden of proof is taken, for example, by Australia, Brazil, Canada, India, South Africa and the United States.

10.1.8.5 Once the taxpayer discharges this burden, it may shift to the tax authorities to evaluate and prove if the controlled prices have been determined in accordance with the arm's length principle or if the information or data used in the computation are unreliable or incorrect. Therefore, countries may assess and determine transfer pricing adjustments in the following situations:

- The related-party transaction was not determined in accordance with the arm's length principle;
- The taxpayer did not supply sufficient information or proof to properly examine the related party transaction;
- The taxpayer did not present tax returns; or
- The arm's length price cannot otherwise be determined.

10.1.8.6 Subsequently, the burden of proof may return to the taxpayer in order to explain and document if the assessment is incorrect, unfounded or unreasonable, and to confirm that the related-party transaction was conducted at arm's length. This situation can occur as part of an audit process or in defence procedures (e.g. litigation process).

10.1.8.7 Tax administrations and taxpayers may encounter several challenges in meeting their respective burdens of proof. As a practical matter, associated enterprises normally establish the conditions of a transaction at the time the transaction is undertaken. In auditing these transactions, the tax administration may have to engage in a verification process perhaps some years after the relevant transactions have taken place. Moreover, at some point the associated enterprises may be required to prove that these transactions are consistent with the arm's length principle. As a part of the due diligence process, the arm's length principle may result in a compliance burden for the taxpayer and an administrative burden for the tax administration in evaluating significant numbers and types of the transactions. The tax administration would review any supporting documentation prepared by the taxpayer to show that its transactions are consistent with the arm's length principle. The tax administration and the taxpayer may also need to gather information on the comparable uncontrolled transactions and the market conditions at the time the transactions took place, for numerous and varied transactions. Such an exercise usually becomes more difficult with the passage of time. In such instances, both taxpayers and tax administrations often have difficulty in obtaining adequate information to apply the arm's length principle.

10.1.8.8 It should be noted that in practice the burden of proof is not always a deciding factor. The burden of proof requirement nevertheless plays an important role in deciding who should disclose what. Since burden of proof is a general issue emanating from the law of each country, the issue of whether the taxpayer or tax administration has the initial burden to prove that the pricing is in accordance with the arm's length principle should be handled within the domestic legal framework.

10.1.8.9 Another important point that should be addressed in transfer pricing domestic legislation is the "statute of limitations" issue — the time allowed in domestic law for the tax administration to complete transfer pricing audits and make necessary assessments. Since a transfer pricing audit can place heavy burdens on the taxpayers and tax authorities, the normal "statute of limitations" period for taking action is often extended compared with general domestic taxation rules. However, too long a period during which adjustment is possible leaves taxpayers in some cases with potentially very large financial risks. Differences in country practices in relation to time limitation should not lead to double taxation. Countries should keep this issue of balance between the interests of the revenue and of taxpayers in mind when setting an extended period during which adjustments can be made.

10.1.9 Presumptive Taxation Approaches and the Arm's Length Principle

10.1.9.1 A "presumptive taxation" approach has been provided in the laws of some countries. Presumptive taxation provisions give tax authorities the power to "presume" an arm's length price based on information gathered by the authorities, and to reassess the taxpayer's taxable income on that basis. Such provisions are generally only regarded as applicable in case of the taxpayer's failure to provide relevant documentation on the arm's length price within a reasonable time (such as when information is requested of a taxpayer during an audit). Presumptive taxation is usually provided for as a last resort.

10.1.9.2 This methodology may be common in legislation related to domestic taxation and transfer pricing adjustments. However, transfer pricing adjustments in relation to cross-border transactions generally create a risk of international double taxation and may be contentious. Countries should therefore structure legislation on presumptive taxation carefully and in a manner that is as consistent as possible with the arm's length principle.

10.1.9.3 The effectiveness of presumptive taxation depends on the approach adopted by the country concerned i.e. the choice between self-assessment and being assessed by the tax administration. On the one hand, under a self-assessment system where the tax authorities have the burden of proof whenever they propose an adjustment, presumptive taxation may appear more attractive when there is not enough relevant information to compute the arm's length price. On the other hand, in an anti-avoidance focused system where taxpayers have an initial burden of proof on the authorities' adjustments, a penalty system may play a more effective role than presumptive taxation to avoid the generalized mispricing of related party transactions.

10.1.9.4 Another issue closely related to presumptive taxation, but also relevant to other systems, is the use of "secret comparables". See further 3.6.7.

10.1.10 Transfer Pricing Information Requirements

10.1.10.1 As a policy choice, governments should decide when, how and in what format they want to receive transfer pricing information. The form should be the most convenient format for the tax administration to process and respond to the information received, if required.

10.1.10.2 Disclosure requirements included in legislation may be part of the regular submission of annual returns at the end of accounting/assessment periods or be required as a result of the conclusion of a transaction. In these cases, taxpayers are required to inform the tax administration of the existence of a related party transaction, and to provide the details of that transaction.

10.1.10.3 On the other hand, the legislation may require the taxpayer to retain the information and provide it to the tax administration only upon request. In that case the taxpayer has the responsibility to have adequate documentation to prove that the transaction was effected at arm's length if required or challenged by the tax administration.

10.1.10.4 An example of information requirements on transfer pricing in filing the annual income tax return is a related party transactions reporting form. One specific example is the Australian International Dealings Schedule that has to be filed together with the annual corporate income tax return. Another example is the Brazilian Certified Digital Tax Bookkeeping (*Escrituração Contábil Fiscal* – ECF) where the taxpayer is required to report all transfer pricing transactions taking place on an annual basis. The South African transfer pricing questionnaire, required to be submitted with the annual corporate tax return, is another relevant example.

10.1.10.5 The mandatory disclosure of key information is the most suitable option for tax administrations with capacity constraints — it may, as a result, be the preferred option for a developing country with limited resources to gather taxpayer information. Under this option, it is important for the regulation in force to make disclosure of information a function of the transfer pricing legislation so that the obligation to report derives directly from the main legislation (without any additional administrative requirements). That will provide tax administrations with taxpayer information which would allow them to better target audit procedures. Tax administrations should make sure they have human and technological resources in place to be able to process and benefit from this information, as well as balance the information request with the level of burden to taxpayers.

10.1.10.6 Documentation requirements for transfer pricing are described further in Chapter 12.

10.1.11 Balance to be Struck Between Statute and Subsidiary Regulations

10.1.11.1 As mentioned in 10.1.4.8 above, some tax systems contain a general recognition of the basic aspects of a tax obligation, and then issue more extensive regulations explaining how the rules should apply in practice. For the purposes of this chapter, this essentially means recognizing the arm's length principle and the basic principles applicable to transfer pricing through the primary legislation.

10.1.11.2 There are some countries where all transfer pricing rules are provided in the domestic substantive/primary tax legislation without further provisions in subsidiary regulations. Such provisions are binding on the taxpayer and the tax administration.

10.1.11.3 In some jurisdictions the substantive provisions to observe the arm's length principle are included in statute but details are then set out more comprehensively in subsidiary regulations. Depending on the country, subsidiary regulations may have the weight of law and are therefore binding for tax authorities and taxpayers.

10.1.11.4 Sometimes domestic tax systems are not able to confer the appropriate weight of authority to the accompanying regulations (as a result of the way the domestic tax system is organized or due to the legal system), or the bulk of the interpretative provisions are only prescribed through administrative guidelines (circular letters). These may be binding for the tax authorities, but not taxpayers. That is, the taxpayer can rely on, but may not be bound by, those rules.

10.1.11.5 Developing countries should assess which system is most suitable considering their own domestic tax legislation. Objective statutory provisions tend to provide greater certainty because they are binding on all parties. Consideration should also be given to the status of rulings provided to specific taxpayers where applicable. See further section 10.3.2.2 and following for details on advance rulings.

10.2 Transfer Pricing Rules in National Tax Regimes

10.2.1 Domestic Rules

10.2.1.1 Article 9 (Associated Enterprises) of the UN and OECD Models sets out the basic conditions for transfer pricing adjustments and for corresponding adjustments where economic double taxation arises. Although Article 9 endorses the application of the arm's length principle it does not set out detailed transfer pricing rules. The Article is not considered to create a domestic transfer pricing regime if this does not already exist in a particular country. Countries must therefore formulate domestic legislation to implement transfer pricing rules. Generally, countries apply their domestic transfer pricing rules to cross-border transactions, but some countries opt to apply transfer pricing rules also to domestic transactions. For such countries, this might be in recognition of the fact that their tax bases can also be eroded through domestic transactions between related parties within the country, particularly where there are a number of different tax regimes in the jurisdiction (e.g. certain types of businesses or transactions that may be subject to different tax rates or special rules). Therefore, it is worth considering that when designing transfer pricing legislation, attention may also need to be given to compliance with the arm's length principle for transactions between related parties within a given jurisdiction.

10.2.1.2 Another aspect worth taking into account when introducing or updating domestic transfer pricing legislation relates to the time lag between the conception and introduction of legislation and its approval by the legislative bodies and entrance into effect.

10.2.1.3 As mentioned in section 10.1.5, there are variations between countries in the definition of an "associated enterprise". The definition often uses a number of factors such as a minimum shareholding level and/or effective control of personnel, financial or trading conditions, or other factors. There may also be a de minimis criterion which means that related party transactions only come within the transfer pricing rules if they exceed a certain threshold. Although international consistency in the definition of associated enterprises and application of the arm's length principle is beneficial, each country must design its transfer pricing legislation in a way that is consistent with its legal and administrative framework, treaty obligations and resources. This can also be an evolutionary process; as the country develops its transfer pricing regime, it will also need to ensure that the administrative rules in other relevant domestic legislation are simultaneously kept up to date.

10.2.1.4 Some countries may include safe harbour rules to exempt taxpayers who have met certain criteria from the need to comply with specific aspects of the transfer pricing rules. This reduces taxpayer compliance costs, increases certainty and also reduces costs of tax collection. The tax administration can focus audit resources on higher risk cases in terms of revenue at stake and risk of non-compliance. Safe harbours may however encourage tax planning and avoidance if they are not carefully designed in terms of scale and scope and/or are incompatible with the arm's length principle. There is also a risk of double taxation and double non-taxation where rules differ between countries. For further discussion see section 10.2.2.

10.2.2 Safe Harbour Rules[97]

10.2.2.1 Safe harbour rules are rules that apply to a category of transactions, allowing the application of simplified transfer pricing rules, or an exemption from the transfer pricing rules. In other cases, the safe harbour may exempt certain transactions or taxpayers from the application of transfer pricing documentation rules, as discussed later. Ideally safe harbour rules approximate outcomes under the arm's length principle to avoid double taxation or double non-taxation, or to avoid creating market distortions. These rules could be limited to taxpayers with a magnitude or amount of controlled transactions below a threshold amount, expressed as a percentage or in absolute terms. A safe harbour rule can be relied upon by a taxpayer as an alternative to a more complex and burdensome approach, such as applying a comprehensive transfer pricing analysis, including a search for appropriate uncontrolled comparables. There are other types of simplified mechanisms for transfer pricing that certain countries also categorize as safe harbours. A safe harbour is normally made available at the option of a taxpayer — it is generally regarded as a condition that the taxpayer can choose to apply or not; see also 10.2.1.4. Other simplified or prescriptive rules which operate similarly to safe harbour rules, but which operate on a presumptive basis rather than at the option of the taxpayer may also apply.

10.2.2.2 Safe harbour or other prescriptive rules can be an attractive option for developing countries with limited access to resources and data (e.g. on comparables), mainly because they can provide ease of administration and predictability of the transfer pricing regime, using simplified rules to establish transfer pricing outcomes. There would be cases where information sourced from tax returns of taxpayers can support the design of safe harbour rules, for instance when the information is in aggregated format and can be made available publicly without breaching confidentiality. Supporters of these types of rules point to the advantages of streamlining compliance, focusing compliance efforts on higher risk or more complex transactions, and providing certainty for taxpayers, as well as administrative simplicity for tax authorities.

10.2.2.3 It is often stated that safe harbour rules allow tax administrations (especially those that are just beginning to administer transfer pricing laws) to focus limited resources, including audit resources, on the more complex and higher risk cases. Given the difficulties of information availability, collection and analysis, many developing countries might consider that at least for

[97] The utility and application of safe harbours and other prescriptive approaches is discussed in PCT (2017).

SMEs or less complicated transactions, safe harbour rules can contribute to minimizing the complexity and burden of establishing transfer prices. These burdens might be disproportionate to the size of the taxpayer or its level of controlled transactions that are subject to the transfer pricing rules.[98]

10.2.2.4 Notwithstanding the notions reflected in the paragraphs above, when considering the introduction of safe harbours, it is necessary to analyze the pros and cons of the proposed measure. This can include e.g. contrasting the benefits in terms of a reduction in administration costs versus forecasted levels of tax collection, as well as the trade-off and impact of the measure on factors such as foreign direct investment, etc.

10.2.2.5 Safe harbour rules may also be useful in relieving SMEs of compliance burdens that disproportionately affect them as compared to larger MNEs (and may affect their ability to compete). Such rules may also relieve similar compliance burdens on taxpayers in relation to small or less risky transactions (e.g. transactions with no unique and valuable intangibles or significant risks). For example, safe harbours can decrease the compliance burden to some extent by their application to a certain class of transactions within a certain defined threshold, such as low value-adding services and interest rates in respect of short-term inter-company "plain vanilla" (i.e. on standard terms) loans of moderate value.

10.2.2.6 There are at least three concepts that safe harbour rules may prescribe: the category of eligible transactions, the transfer pricing method and the corresponding range or result to be used. In this context, even though the first two concepts may be introduced by regulation, administrations may publish the applicable range or result in administrative regulations, in order to ensure that the benchmark can be updated periodically.

10.2.2.7 There are possible downsides to safe harbour and other prescriptive rules, including the possibility of abuse or that the rules diverge from arm's length outcomes. An example of such abuse could include breaking down what is in reality a large transaction into several smaller ones in order to remain within the safe harbour threshold. There is also a risk that taxpayers' lobbying efforts could make it difficult to remove safe harbours when they are no longer needed, or when conditions have changed so that such rules are no longer appropriate. There is also the possible risk that safe harbour rules are too generous; this can result in revenue being unnecessarily foregone. This

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98 OECD (2017). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.* Paris: OECD Publishing. Available from https://doi.org/10.1787/tpg-2017-en. See paras. 4.95 to 4.100.

will also be the case if transactions that would otherwise have been concluded at market prices are priced at the limit of the safe harbour. Or there may be a distortionary impact in that such a regime may encourage and perpetuate an economy based on small-scale or low-profit transactions rather than higher-risk/higher-reward transactions (e.g. technology based) to which the safe harbours will not apply. Safe harbours may thus even discourage investment in high-margin activity as compared to low-margin activities.

10.2.2.8 The section on safe harbours in Chapter IV of the OECD Transfer Pricing Guidelines discusses some potential disadvantages of safe harbour rules, such as the reporting of taxable income that is not in accordance with the arm's length principle, increased risk of double taxation or double non-taxation when adopted unilaterally, potential for creating inappropriate tax planning opportunities, and equity and uniformity issues due to the creation of two sets of rules for transfer pricing. In conclusion, where safe harbours can be negotiated on a bilateral or multilateral basis, they may provide significant relief from compliance burdens and administrative complexity without creating problems of double taxation or double non-taxation. This also can be achieved through unilateral safe harbour rules which both align with the arm's length principle and fall within the scope of double tax treaties (e.g. allowing the other State to understand the technical details behind the safe harbours in order to grant total or partial relief in case it is necessary and feasible). The guidance also states that tax administrations should carefully weigh the benefits of, and concerns regarding, safe harbours, making use of such provisions where they deem it appropriate.[99]

10.2.2.9 Notwithstanding that safe harbours may present certain disadvantages, it is worth mentioning that in the context of small taxpayers or less complex transactions, these might be outweighed by the benefits of such provisions. Provided that the safe harbour is elective, taxpayers may consider that a moderate level of double taxation, if any arises due to the safe harbour, is acceptable given the increased certainty and simplicity. It can be argued that when electing for the safe harbours, taxpayers are capable of making the decision as to whether the possible double taxation is acceptable or not.

10.2.2.10 When designing safe harbours, it is important to consider whether to allow for flexibility to "opt-in" or "opt-out" of the measure. An "opt-in" safe harbour is one where the taxpayer can choose to apply the safe harbour in order to benefit from it. In this scenario, a taxpayer that chooses

99 OECD (2013). *Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines*. Paris: OECD Publishing. Available from http://www.oecd.org/ctp/transfer-pricing/Revised-Section-E-Safe-Harbours-TP-Guidelines.pdf.

not to opt-in must apply the ordinary transfer pricing rules and any associated documentation requirements. An “opt-out” safe-harbour requires the taxpayer to apply the method specified to the relevant transactions unless it actively chooses not to. If a taxpayer opts out, it must apply the transfer pricing rules and any associated documentation requirements, meaning that it bears the burden of proof that its controlled transactions were conducted in line with the arm’s length principle. An “opt-out” regime may thus be a more straightforward option as it has the potential to reduce administrative costs. There is no intrinsic difference in the option taken but it would be necessary to take into account any differences in the burden of proof implied by the choice made.

10.2.3 Safe Harbour Practical Issues

10.2.3.1 In general, safe harbour rules tend to provide an option that exempts taxpayers from complying with general transfer pricing rules in relation to certain transactions. In this regard, if the transactions stay within the safe harbour limits, there may be no need to apply transfer pricing methods and/or maintain contemporaneous documentation mandated in the transfer pricing legislation.

10.2.3.2 The OECD has proposed an elective simplified approach in the form of a fixed margin (5% mark-up on costs) for low value-adding services (*LVAS*).[100] The OECD defines LVAS as services of a supportive nature, not forming part of the core business of the enterprise, and that do not use unique and valuable intangibles or assume significant risks.

10.2.3.3 In addition, the PCT Transfer Pricing Toolkit (see 2.5.3.2) includes a comparative analysis of the country practices on safe harbours applicable to LVAS (i.e. containing information on (i) definition of LVAS; (ii) excluded transactions; and (iii) margin or mark-up for the safe harbour).

10.2.3.4 Some of the most common requirements for a safe harbour regime are listed below:

- ➢ The benefits are aimed at taxpayers engaged in certain activities;
- ➢ The regime is limited to certain conditions or thresholds such as the absolute or relative amount of the transaction;

[100] OECD (2015). *Aligning Transfer Pricing Outcomes with Value Creation*, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project. OECD Publishing, Paris, https://doi.org/10.1787/9789264241244-en. Further, it was incorporated in Chapter VII of the 2017 Transfer Pricing Guidelines.

- Defined margins or results are established by law or administrative practice; and
- Eligibility is limited to transactions where the related party is not resident in a low-tax jurisdiction.

10.2.3.5 For transactions exceeding or otherwise ineligible for the safe harbour limits, taxpayers could be required to comply with all transfer pricing rules.

10.2.3.6 Another aspect arising from some safe harbour experiences internationally is that when fixed margins are established, they could be perceived as being too high, meaning that if optional, they may be unattractive to taxpayers. Furthermore, where the fixed margin is applied the other state may not accept the results as arm's length. In these cases, there may be a significant risk of double taxation.

10.2.4 Downwards Adjustments

10.2.4.1 Since implementation of transfer pricing rules may result in adjustments that increase the amount of tax payable, a taxpayer may seek, on examination, a downward transfer pricing adjustment in taxable income, arising from unintentional over-reporting of taxable income. Guidance provided in the OECD Transfer Pricing Guidelines indicates that tax administrations may or may not grant the request for downward adjustment at their own discretion.[101] Furthermore, tax administrations may also consider such requests in the context of MAP and corresponding adjustments. This is an issue which developing countries should also consider when designing their domestic legal environment for transfer pricing.

10.2.4.2 The Republic of Korea's experience may be considered as an example in this regard. In 2010, the Republic of Korea clarified in its tax law that a downward adjustment should be applied in cases where a tax adjustment is made under a transfer pricing method using multiple year data. Therefore, tax officials are no longer given any discretion to make the adjustment only for years with a deficient profit, and to disregard years with excess profits, when they adjust the taxpayer's profit level under a transfer pricing method using multiple year data.

10.2.4.3 In South Africa, the legislative provision requiring that terms

[101] OECD (2017). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.* Paris: OECD Publishing. Available from https://doi.org/10.1787/tpg-2017-en. See para. 3.17.

and conditions should be adjusted to those that would have existed had the parties been independent persons dealing at arm's length, is limited to situations there has been a tax benefit, and therefore does not in its terms provide for downward adjustments.

10.2.4.4 The Mexican tax administration issued rules for the application by taxpayers of transfer pricing adjustments (i.e. upwards and downward adjustments). The rules (i) define the notion and types of "transfer pricing adjustments"; (ii) set out the timing of application; (iii) indicate the information that has to be compiled by taxpayers regarding the adjustments; (iv) explain the effects that may arise with regards to line items related to withholding; and (v) address consequences of the adjustments on indirect taxes (VAT).

10.2.4.5 It is also important that provisions for downward adjustments do not create opportunities for non-taxation. For example, taxpayer A in country A makes a request to decrease the price of goods sold to related party B in country B from 100 to 80 in accordance with the arm's length principle, thereby lowering its income by 20. The newly determined arm's length price implies that the income of B should be increased by 20. However, if this corresponding upward adjustment is not made, the 20 of income will be taxed in neither country. This risk of double non-taxation is highest in cases where a taxpayer has initiated a request outside of a MAP or APA process, and information on the position of the related party, or parties, in the other jurisdiction(s) is missing.

10.2.4.6 Where the taxpayer has initiated downward adjustments, and a tax administration accepts in principle that a downward adjustment should be made, the taxpayer may be required to provide evidence that the amount has been included in income by a related party in the other jurisdiction. Alternatively, the competent authority of the country agreeing to the downward adjustment should spontaneously exchange information about the downward adjustment with the competent authority of the other jurisdiction, so that the latter competent authority can consider whether additional income should be recognized in its jurisdiction.

10.2.5 Advance Pricing Agreements/Arrangements (APAs)

10.2.5.1 Many countries have introduced APA procedures in their domestic laws though these may have different legal forms. For example, in certain countries an APA may be a legally binding engagement between taxpayers and tax authorities, while in other countries it may be a more informal arrangement between the tax authorities and the taxpayer. APAs are a useful dispute avoidance mechanism and are discussed in further detail in Chapter 15., including the considerations for proper operation of APA procedures, and the advantages and disadvantages of APAs. Consideration of APA programmes may be needed at different stages of the design of a legal framework for transfer pricing.

10.2.5.2 When implementing APAs, tax administrations have to bear in mind that the APA process is, in practice, a service to taxpayers. Consequently, appropriate capacity must be available in the tax administration to adequately respond to demand for APAs, including in terms of response time, volume of requests, complexity of cases, etc. In addition, within a legislative design context, taxpayers may be required to pay fees when filing an APA request to cover the actual costs of processing APA requests.

10.2.5.3 Some consider adequate levels of experience to be necessary before APAs become appropriate, while others see the experience gained in concluding APAs as an important part of capacity-building on transfer pricing issues. Matching operational capability to offer APAs with the general operational capability of the transfer pricing regime is thus an important factor in the design of the domestic legal framework.

10.2.5.4 Some countries choose not to have APAs, at least for some time after their transfer pricing regime is put in place. For example, they may feel that they need to develop capacity and skills before they can properly evaluate what is an appropriate APA system for them.[102] Other countries are concerned that APAs are not useful in a transfer pricing regime because they tend to be sought by companies that are in broad conformity with the arm's length principle and may divert scarce resources from achieving compliance in the worst cases of avoidance. As with any such mechanism, checks and balances must be provided to ensure that the APA process is applied consistently between taxpayers and is not subject to abuse or integrity issues. The issues involved in balancing resource issues and priorities with the potential benefits of APAs are discussed in more detail at 15.3.4.

[102] After almost a decade of experience of implementation of transfer pricing regulations in the country, India introduced APAs with effect from 1 July 2012 in the Income Tax Act. Financial Year 2013-14 was the first year that APAs came into effect. Since then India has signed more than 300 unilateral and bilateral APAs.

10.2.6 Interaction of Transfer Pricing Provisions with Domestic Tax Rules

10.2.6.1 In designing a domestic tax system, consideration must be given to the interaction of transfer pricing rules with any applicable Controlled Foreign Corporation (CFC) rules. CFC rules are designed to prevent tax being deferred or avoided by taxpayers using foreign corporations in which they hold a controlling shareholding in low tax jurisdictions. Without CFC rules, income could be left in low tax jurisdictions and remain outside the scope of domestic tax rules. CFC rules treat this income as though it has been repatriated and it is therefore taxable in the hands of the resident shareholders. It is widely considered that the transfer pricing rules should have priority and the CFC rules should apply to the profits remaining in controlled foreign companies after application of the arm's length principle.

10.2.6.2 It may sometimes be more advantageous for tax purposes to finance a company by way of debt than equity, as the interest paid on debt may be deducted for tax purposes while dividends on equity may not be tax deductible. In many countries, thin capitalization or other interest limitation provisions have been introduced to deny a deduction for excessive interest payments. This is done by prescribing a maximum debt-to-equity or (net) interest to EBITDA ratio and disallowing a proportion of interest payments if the ratio is exceeded (see section 9.5). These rules protect the tax base by discouraging cross-border shifting of profits through excessive interest payments on debt. From a policy perspective, failure to tackle base eroding interest payments gives MNEs an advantage over purely domestic businesses which are unable to gain such tax advantages.

10.2.6.3 Some countries that do not have detailed transfer pricing rules in place may deal with abusive forms of transfer pricing through the use of a general anti-avoidance rule (GAAR). Abusive non-arm's length transactions may come within the scope of the GAAR. This may be useful in the early stages of introducing a transfer pricing regime; however, use of the GAAR in transfer pricing issues may create uncertainty for business and detailed transfer pricing legislation, regulations or guidance may thus be preferable.

10.3 Keeping Transfer Pricing Regimes Updated

10.3.1 Gathering Information

10.3.1.1 This section provides information to developing countries about resources available to follow the latest developments in international tax rules and initiatives. It also provides guidance on the mechanisms available for developing countries to obtain training, information updates and to engage in international tax dialogue upon implementing transfer pricing rules. Such resources will assist countries to keep abreast of developments, exchange peer experiences and keep their transfer pricing regimes updated.

Regional Coordination Through Existing Intergovernmental Agencies

10.3.1.2 One of the suggested approaches to keep up to date with developments in international transfer pricing rules is to engage with regional intergovernmental agencies such as Cercle de Reflexion et d'Echange des Dirigeants des Administrations Fiscales (CREDAF), Intra-European Organisation of Tax Administrations (IOTA), Inter-American Center of Tax Administrations (CIAT), the African Tax Administration Forum (ATAF), Study Group on Asian Tax Administration and Research (SGATAR), the Pacific Islands Tax Administrators Association (PITAA), and the Commonwealth Association of Tax Administrators (CATA).

10.3.1.3 These are non-profit international public organizations that may be able to provide specialized technical assistance for the modernization and strengthening of tax administrations in different regions of the world, through conferences, targeted field missions, exchange of information, and sometimes even targeted training. As their names indicate, they tend to cater for a specific geographic region, or a particular group of countries. Some countries are members of more than one regional organization:[103]

- CIAT's predominant membership is from the Americas;[104]
- ATAF's membership is primarily of African countries;
- SGATAR's membership is located in the Asia-Pacific region;
- PITAA's membership is drawn from the Pacific Islands; and
- CATA's membership draws from a number of Commonwealth countries spread over all geographic regions of the world.

Engagement with Institutional Stakeholders

10.3.1.4 The UN, OECD, World Bank Group and the IMF are all agencies which consistently engage with countries on international tax issues and provide capacity development assistance. Countries generally need to request training which may be specific to the requesting country, or may be provided

[103] For example, Australia is an Associate Member of both SGATAR and CATA.

[104] There is a special category of associate member. CIAT's General Assembly may accept as Associate Members countries from regions other than the Americas that apply for accession and have the approval of the Executive Council. There are currently 5 European countries, 2 African countries and 1 Asian country in CIAT's membership.

regionally, in the context of a larger group of tax administrators.

10.3.1.5 The UN and the OECD have standing committees which meet regularly to discuss existing and emerging issues in transfer pricing. Following these processes is key to keeping domestic transfer pricing regimes updated. Engaging in international tax dialogue is also a means to obtaining updated information with respect to the latest developments in transfer pricing.

10.3.1.6 The PCT, a joint initiative of the UN, OECD, World Bank Group and the IMF, has issued a number of toolkits on international tax issues of particular relevance to developing countries, including transfer pricing.

10.3.1.7 Some national and regional tax administrations also provide very good guidance in the field of international taxation in general, and transfer pricing specifically, in areas where they themselves face difficulties in compliance and policy formulation, as well as providing their interpretation of certain international tax provisions. These national tax administrations, regional organizations and others could be followed and even consulted by developing countries wishing to resolve perhaps similar problems arising as a result of the application of their own transfer pricing rules.

10.3.1.8 Finally, some academic institutions, research centres and think tanks have funds to invest in capacity development in developing countries and encourage their experts to provide such assistance.

Create a Clearing House for Information and Capacity Development with Like-minded Countries

10.3.1.9 Like-minded tax administrations should come together to share experiences and tax information which they consider useful for other tax administrations. That is particularly relevant for countries that share borders, have similar legal backgrounds or may be part of a regional economic group.

10.3.1.10 By acting within an organized group, tax administrations can share training expenses while promoting capacity development, disseminating knowledge, and sharing training content received from intergovernmental institutions.

Participate in the South-South Dialogue for Capacity Development

10.3.1.11 In general, tax authorities in developing countries lack sufficient qualified and experienced personnel to deal with controversial transfer pricing issues, especially in view of global developments around new, rapidly developing topics such as BEPS. Regular training, information exchange and experience sharing and even foreign language skills, are all examples of aspects that are necessary for capacity development. A knowledge sharing platform with other tax authorities (a regional institution, or a clearing house institution) could be an important step in this regard. International secondments to gain more experience at the UN, the OECD or in another tax administration should be considered if possible. An independent external consultancy body might also be an option, as explained below. Other capacity development issues are covered in detail in Chapter 11.

10.3.1.12 A risk of miscommunication between taxpayers and revenue authorities is one of the main challenges in countries where transfer pricing regulations are relatively new. A greater pool of transfer pricing experts would be helpful to revenue authorities and taxpayers who are trying to address complex transfer pricing issues in such countries. A pool of experts might be found from engagement with regional intergovernmental organizations, neighbouring countries, countries sharing the same language or from active participation in South-South dialogue. These experts could assist, e.g. revenue authorities and taxpayers in advanced dispute resolution processes to provide expert perspectives. This could be a short-term solution to help to reduce the number of protracted enquiries where taxpayers have tried to apply approaches that are consistent with international principles.

10.3.1.13 The joint UNDP-OECD initiative called Tax Inspectors Without Borders (TIWB) may be an additional source of expertise combining expertise from both developed and developing country tax administrations.

10.3.2 Examples of Measures to Update Transfer Pricing Regimes

10.3.2.1 This section seeks to provide advice on the instruments that exist for tax administrations to introduce policies that draw upon the current international discussions, without having to go through the whole legislative process in modifying tax legislation.

Advance Tax Rulings

10.3.2.2 Tax rulings work very similarly to APAs. One of the differences between them is that a tax ruling can be granted on any tax issue, and an APA relates only to the application of the transfer pricing rules. Another difference is that a tax ruling is unilaterally issued by the tax authority, while an APA reflects an agreement of both the taxpayer and tax authority. As under an APA, tax rulings tend to grant greater legal certainty by establishing, a priori, the correct tax treatment in relation to a particular issue or transaction. A ruling may also be used to attract foreign direct investment, assuming that the tax administration uses the tax ruling to bring certainty.

10.3.2.3 Tax rulings also help create an active tax dialogue between taxpayer and tax administration and may stimulate greater cooperation by encouraging taxpayers to come forward with queries in exchange for early certainty. Since tax rulings are tailored to a specific taxpayer or group of taxpayers, they can also be used to clarify the interpretation of domestic tax legislation as it applies in a particular situation, without having to make changes to the statute or supporting regulations. To that extent, and because the legislative process runs a lot more slowly than the conferral of an administrative decision, a rulings programme might be helpful in allowing countries to follow the trends set in the international scene. A country wishing to grant tax rulings needs to have the legal basis for it in its domestic tax legislation.

10.3.2.4 In accordance with the minimum standard, Action 5 of the BEPS Report also establishes a commitment to transparency through the compulsory spontaneous exchange of relevant information on taxpayer-specific rulings.

10.3.2.5 Depending on the design of tax rulings, they can be a useful starting point in avoiding disputes between the taxpayers and tax administrations as discussed in Chapter 15.

Establish an International Consultancy Body

10.3.2.6 Developing countries might benefit from establishing an independent organization (an expert body, composed of academics, industry experts, and/or government officials) to advise them on the ways through which they might be able to fine tune or update their legislation. An independent advisory group could suggest updates, point out controversial issues in the country's legislation, suggest action in certain transfer pricing areas, and even audit the country's tax legislation for improvement.

10.3.2.7 Developing countries could, through participation in regional and global dialogues, benefit from the use of existing consultancy bodies used by countries with similar legislation, or countries located within the same geographic region. This may help manage costs if countries opt to be evaluated contemporaneously with each other. The effort could be hosted in an existing cooperation organization, as mentioned above, or within a UN specialized organization to further manage costs. Regional organizations, such as ATAF and CIAT, are known to have also provided similar capacity for their member countries.

11 Establishing Transfer Pricing Capability in Developing Countries

11.1 Introduction

11.1.1 This Chapter addresses issues involved in setting up a dedicated transfer pricing unit in the tax administration to administer the country's transfer pricing rules. There are important opportunities as well as challenges in setting up such a unit for the first time. The design of such a unit, its vision and mission statement and the measurement of whether it has been successful must take into account factors such as:

- The relationship between the tax policy function and the tax administration function;
- The need to evaluate current capabilities and gaps to be filled;
- The need for a clear vision, a mission and a culture that will facilitate effective administration of the law;
- Organizational structure;
- Approaches taken to building team capability;
- The need for effective and efficient business processes;
- The advantages of staged approaches to reaching long-term goals; and
- The need for monitoring to assess effectiveness and for ongoing fine tuning of the organizational structure and administrative processes.

11.1.2 These points provide a useful framework when setting up a transfer pricing unit. There is no perfect "template" that will be suitable for all countries in every respect. These issues will all need consideration in the context of the country's overall tax administration and legal structures.

11.2 Relationship between Tax Policy and Tax Administration

11.2.1 In most countries, the tax policymaking function generally resides with the Ministry of Finance rather than with the tax administration. The other revenue collecting organs of government (e.g. the Customs service)[105] are also often separate from the tax administration. There is, however, a particular need to bridge the gap between the policymaking function and the tax administration in order to implement an effective transfer pricing regime. This need arises due to:

- The complexity and resource intensiveness of administering a transfer pricing regime;
- The potential costs of compliance for taxpayers and of collection by tax administrations;
- The large amounts of money that may be at stake; and
- The international dimension given the link to binding tax treaties through provisions based upon Article 9 of the UN and OECD Model Conventions, issues of potential double taxation, and the interests of other countries.

11.2.2 The respective responsibilities and functions relating to tax administration and policymaking should be clear. Mechanisms for contact and coordination between the two should be well understood. Duplication and overlap of functions should be avoided, and processes for coordination between the two should be streamlined.

11.2.3 Some factors that could improve cooperation between the functional areas include:

- Recognition of the need to have a "policy feedback loop" so that the policy reasons for a transfer pricing regime are properly reflected in the design of that regime and in its administration, and so that practical lessons from the administration of the regime can provide feedback in order to fine tune policy. Examples are:
  - Where aspects of the policy are expensive or otherwise very resource intensive to administer, and the likely revenue return is not commensurate with these costs;
  - Where a wider treaty framework and strong exchange of information provisions would be beneficial; or where there is a need to ensure that the framework of thresholds, deterrence mechanisms, and penalties is effective and up to date; and

[105] WCO (2018). *Guide to Customs Valuation and Transfer Pricing.* Brussels: WCO. Available from http://www.wcoomd.org/-/media/wco/public/global/pdf/topics/key-issues/revenue-package/wco-guide-to-customs-valuation-and-transfer-pricing.pdf?la=en. Customs are relevant for transfer pricing in relation to issues of valuation. See, for example, the discussion at Chapter 3 and para. 3.6.6 et seq. of this Manual.

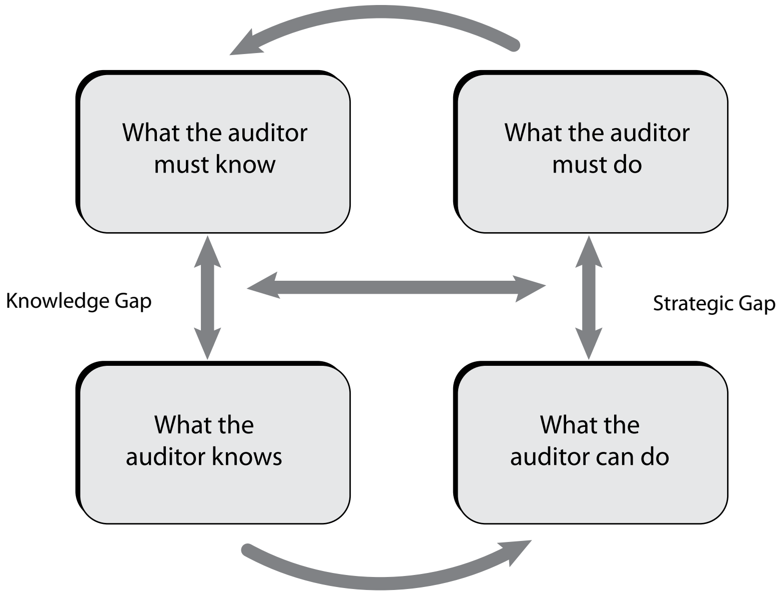
  - Where the experience of the administration in taxpayer service, education, enforcement, and case resolution can aid in improving legislation or implementing regulations;
- Cross-secondment of tax administrators and policymakers to each other's teams can help ensure that administration officials understand the policymaking process and the objectives of the legislation, and that policymakers understand the practical issues of tax administration. Good tax policy must be capable of being administered and good administration must have sound policy underpinnings; and
- Involvement of the tax administration in developing investment policies, including involvement in discussions about tax incentives that may affect transfer pricing and other aspects of tax administration.

11.3 Assessing Current Capabilities and Gaps to be Filled

11.3.1 Different tax administrations require different types of administrative arrangements when it comes to implementing a particular country's transfer pricing policies. The level of development/capability in the tax administration should be a key factor to consider when formulating policies. In many cases, there is an unrealistic expectation that increases in capability across many areas can be achieved in a short time. Skill in administering transfer pricing rules can only be developed by practical experience in addressing actual transfer pricing cases.

11.3.2 In addressing the issue of building transfer pricing capability, it is important to realistically evaluate the actual level of existing knowledge and the best organizational approach. The focus in this Manual is on countries with little or no existing experience in transfer pricing, so there are initial start-up issues. There is also a recognition that not everything can be achieved at once and that the system and the administrative capability will need to evolve over time through practical experience and as part of a capacity building plan. This is sometimes termed a "life cycle approach". A possible approach is outlined below in Figure 11.D.1.

Figure 11.D.1



Source: Choo, C. W., & Bontis, N. (Eds.). (2002). *The Strategic Management of Intellectual Capital and Organizational Knowledge.* Oxford: Oxford University Press.

11.3.3 Factors to consider when assessing the level of development/capability of the tax administration include:

- Levels of education and expertise of personnel involved with administration of transfer pricing rules;
- The legal environment or framework (as addressed in Chapter 10.) including the characteristics of the transfer pricing legislation and responsibilities for and the scope of regulations. A clear and transparent legal framework is important to the functioning of the administration as a whole;[106]
- Whether or not a network of comprehensive bilateral tax treaties exists, including articles relating to Associated Enterprises (usually Article 9), the Mutual Agreement Procedure (usually Article 25) and Exchange of Information (usually Article 26). Additionally, the existence of any more limited exchange of information agreements should be evaluated—especially with

[106] Baer, K., Benon, O. P., & Toro, R. J. (2002). *Improving Large Taxpayers' Compliance: A Review of Country Experience, Occasional Paper,* (IMF vol. 215). Washington: IMF. Available from http://www.imf.org/external/pubs/nft/op/215/.

the countries of residence of key participants in the economy and their related parties;

- ➢ Availability of necessary economic and financial information within the country/tax administration; and
- ➢ Availability of information technology systems that allow for the most effective strategies to encourage compliance, develop and support audit strategies and facilitate collection and litigation where necessary, as well as availability of personnel skilled in using such systems.

11.4 Developing the Mission, Vision and Culture of the Transfer Pricing Unit

11.4.1 Objectives

11.4.1.1 The objectives of the transfer pricing team should be clear, both to team members and to others they are engaging with. This includes other persons in the administration, those involved in the tax policy function, and stakeholders such as taxpayers and their advisors. Often this is put in terms of developing a "mission statement" reflecting what the transfer pricing unit will do in its daily operations and a "vision" representing what an ideal future will look like when the unit carries out its mission properly. Many tax administrations also have a "Taxpayer's Charter" which reflects what taxpayers can expect from the administration, and what is expected from taxpayers in their relationship with the administration.

11.4.1.2 Documents reflecting the mission and the vision should become part of the culture and be "lived out" by the unit on a daily basis. This will be assisted by, for example, developing a team charter aligned with the wider organizational charter agreed by senior managers in the transfer pricing unit and key persons in the tax administration as a whole, preferably after input from stakeholders. This could usefully draw upon the experience of other countries, though it must be tailored to each country's own realities. It is of course necessary to monitor the achievement of the mission and vision in practice and, if the mission and vision have not been achieved, to identify the reason for that.

11.4.1.3 An important part of defining the unit's objectives involves identifying and recognizing the limitations on available resources. Clearly determining what is inside and outside the competence of the unit will help clarify what resources are needed to meet the objectives of the unit and encourage the best use of such resources.

11.4.2 Client/Taxpayer Orientation

11.4.2.1 A central consideration to be borne in mind is that a transfer pricing unit will have important taxpayer service and education functions as well as an enforcement function. These functions are interrelated: better education and taxpayer service reduces the cost, resource-intensity and "pain" of compliance. This, in turn, helps increase compliance (those wanting to comply find it easier to do so) and allows the administration to focus enforcement measures on the greatest risk areas (in particular, on taxpayers that are unwilling to comply with their obligations).

11.4.2.2 Understanding the functions and environment of MNEs will further the tax administration's service, education, and enforcement activities. Handling their taxation issues will inevitably lead to more contacts between MNEs and the transfer pricing unit. For instance, MNEs have to disclose their documentation and systems, while tax administrations have to be aware of the dangers of unnecessarily high administrative burdens, and therefore compliance costs, for MNEs. High compliance costs are inefficient and may unnecessarily give a negative view of a country's investment climate, deterring potential investors.

11.4.2.3 On the other hand, increased focus on transfer pricing issues will inevitably lead to some disputes with MNEs and the possibility of double taxation. For example, in a related party transaction involving entities in two countries (A and B), Country A might assert that more profits from the transaction are subject to its tax jurisdiction in accordance with a bilateral treaty, resulting in fewer profits being (in Country A's view) subject to tax in Country B. This is an increasingly common issue in transfer pricing and tax administrations need to devote sufficient resources to avoid unnecessary differences of opinion. They need to ensure, where possible, that those differences do not lead to unnecessary disputes and they need to deal with formal dispute resolution procedures as expeditiously and effectively as possible when a dispute cannot be avoided.

11.4.2.4 Most double tax treaties contain a Mutual Agreement Procedure (MAP) article (usually Article 25), based upon the UN or OECD Model Tax Conventions, that is designed to avoid double taxation. However, MAP can be very resource-intensive and costly for both tax authorities and MNEs. As such, it is especially worthwhile to put sufficient energy and resources into risk assessment and establishing contact points between the tax administration, the competent authorities under tax treaties, and policymakers to avoid unnecessary adjustments in tax assessments. See 15.5 for details on MAP.

11.4.2.5 Engagement with taxpayers and their tax advisors is necessary to understand the transfer pricing systems and practices of MNEs, and for the MNEs to understand what is required from them in a newly introduced transfer pricing regime. This will help taxpayers and the tax administration to explore shared interests in clarity, transparency, and certainty, to understand and reduce the risks of aggressive tax positions, to increase awareness of commercial realities, to promote fairness and consistency between taxpayers, and to reduce the costs of compliance and collection.

11.4.2.6 There is a need for considerable early investment in taxpayer education. The tax administration also needs to ensure professional and effective relationships with taxpayers as an element of taxpayer service. This is one area where the experience of other similarly placed administrations is likely to be especially helpful.

11.4.2.7 Overall, there needs to be a sustained commitment to this part of the "set up process", which is designed to maximize compliance and to assist in risk management (by helping differentiate non-compliance due to lack of understanding from more deliberate and therefore systemically risky non-compliance). A fair amount of institutional patience and sustained commitment is required if the transfer pricing regime is to fully meet its medium- to longer-term goals.

11.4.2.8 Some specific steps through which this can be achieved by tax administrators include:

- Knowing taxpayers and their commercial environment, as well as their main issues and concerns, and having in place continuous dialogue with taxpayers, tax professionals and their associations or peak representative bodies on tax issues;
- Being reasonable and proportionate in actions, and open and transparent with taxpayers;
- Being responsive to requests;
- Extensive and clear taxpayer education, including making tax guidance notes, information circulars and other guidance on interpretation of tax laws available to taxpayers to help avoid misunderstanding, confusion and surprises to those willing to meet their obligations;
- An informative and easy to navigate Internet presence that is regularly tested and kept under review for its user-friendliness and relevance;
- Seeking to avoid disputes arising unnecessarily but also setting up clear and fair systems for addressing such disputes that do not unfairly deter taxpayers from pursuing legitimate grievances; and

- Providing a process for obtaining advance rulings and advance pricing agreements on specific issues as appropriate.

11.4.2.9 Steps that could be encouraged among taxpayers and their advisors include:

- Being transparent and open about their risks, including by making timely voluntary disclosures to the tax administration;
- Preparing accurate and complete transfer pricing documentation in accordance with the guidance on documentation (see Chapter 12 of this Manual);
- Requesting and obtaining advance rulings before embarking on activities with important tax consequences, or participating in advance pricing agreements where they exist;[107]
- Making their transfer pricing policy available to the tax administration as part of required documentation;
- Recognizing the resource limitations on the side of the administration and not "playing games" to tie up those resources unnecessarily to the disadvantage of the administration and other taxpayers; and
- Complying with and understanding the requirements and limitations of the bilateral double taxation treaty between the country they are operating in and the country of their headquarters or associated enterprises.

11.4.3 The Enforcement Approach: A Risk-Based Approach to Compliance

11.4.3.1 A "risk management" approach to the unit's work is recommended; this is true for the tax administration as a whole, but particularly when dealing with a new regime involving the complex and resource-intensive issues of transfer pricing. This means having robust processes in place for:

[107] The issue of whether to institute an APA programme is a complex one, which is addressed in Chapter 15 of this Manual. Some countries see this as a useful extension of the risk management approach even in the early days of a transfer pricing regime. Others consider that this is more appropriate once there is greater familiarity with and experience of transfer pricing issues and prefer to focus limited resources in the start-up phase on the most serious instances of non-compliance rather than on taxpayers likely to be in broad compliance.

- Identifying transfer pricing risks;
- Analyzing risks (including prioritizing them in terms of their likelihood and their impact should they occur); and
- Determining what can be done to avoid risks or to limit their adverse consequences if they cannot be avoided.

The obvious risk is that taxpayers do not comply with the law, but other risks, such as risks to public confidence in the system if taxpayers are not seen as meeting their tax obligations also need to be considered.

11.4.3.2 Issues and procedures related to risk assessment and management are considered in more detail in Chapter 13 of this Manual. In setting up a transfer pricing unit, however, it should be recognized that there is an important role for officers attuned to the organization's approach to risk management and able to implement it systematically for a new area and keep it under review. Consistent risk management strategies will often be developed in conjunction with other areas of the administration, such as those dealing with tax treaties, specializing in the tax affairs of relevant industries or in offices that are differentiated based on the size of a taxpayer.

11.4.3.3 As part of this risk management approach, it is important to identify the areas of focus. For example, developed countries with long established transfer pricing regimes and administrations tend, in practice, to have criteria that define their areas of greatest or least current focus. This often includes thresholds below which they would generally not audit or adjust a controlled transaction for transfer pricing purposes, especially in relation to small and medium-sized enterprises or for transactions below certain values.[108]

11.4.3.4 The criteria referred to above will have to be assessed for each country in the light of its own circumstances and will have to be kept under review to make sure these criteria are not subject to abuse.

11.5 Organizational Structure for the Transfer Pricing Unit

11.5.1 Introduction

11.5.1.1 An important part of implementing a transfer pricing regime is determining which part of the tax administration should undertake transfer pricing work. The generally observed options include:

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[108] OECD (2011). *Multi-Country Analysis Of Existing Transfer Pricing Simplification Measures.* Paris: OECD Publishing. Available from https://www.oecd.org/ctp/transfer-pricing/48131481.pdf

- Creating a transfer pricing department or division, tasked with the responsibility to handle all transfer pricing work;
- Placing the transfer pricing work within an international operations group within the tax administration; or
- Considering compliance with the transfer pricing regime a part of the compliance responsibility of all taxpayers subject to these rules, and seeking to train all officers who are likely to face transfer pricing issues.

11.5.1.2 In addition to one of the three options above, tax administrations also have the option of creating specially designated teams or divisions within other departments, to deal with high profile cases, special cases or with certain groups of taxpayers. In this case, countries might also consider:

- Placing the work within a Large Taxpayers Unit/Office (LTU/LTO) and building up capacity of officials working within that office in transfer pricing.
- Developing transfer pricing capacity in specific industry-focused units which the tax administration considers to be particularly important to the economy and/or susceptible to transfer mispricing—e.g. pharmaceuticals, automotive, oil and gas, mining and natural resources, etc.

11.5.1.3 The choice to be made by a particular country will depend on its circumstances and capacity. The choice may also be dynamic. For example, in the early stages of the regime being implemented, the transfer pricing work can be concentrated in the part of the tax administration that deals with international tax issues. As capacity is built and more cases are seen, a new section can be created within the LTU/LTO where the most high-profile cases may be expected to emerge. Over time, more specialist knowledge can be built up and spread wider across the tax administration.

11.5.1.4 Some tax administrations have organized themselves based on taxpayer segmentation according to size or industry sector allowing for the creation of centres of competence or expertise in dealing with issues common to the segment. Such units are often part of an administration structured along functional lines, focusing on the taxpayer as the administration's "customer". A principal objective of taxpayer segmentation is to minimize compliance costs. It is quite common to allocate the transfer pricing inspection division to the LTU/LTO, which is then considered the central repository of experience.

11.5.1.5 Such an allocation of responsibilities can foster evolving and increasing learning approaches. A good example is Brazil where the transfer pricing programme in the LTO (known as the DEMAC) focuses its audits mainly on specific sectors such as pharmaceuticals and automobiles. However, as the audit teams continue to grow in sophistication in their approaches, and also in number and experience, the focus has become broader.

11.5.1.6 Finally, the design of a good tax administration must include an effective audit programme capable of detecting and penalizing non-compliant taxpayers. Such an audit programme could grow out of a larger compliance team and could include industry and/or issue-oriented audits, comprehensive regular audits of specific businesses that fall within risk criteria and fully-fledged tax fraud investigations. Joint investigation programmes to deal with suspected cases of non-compliance for corporate income tax and indirect taxes, such as value added tax (VAT), may also be planned by more sophisticated tax administrations. See further Chapter 14 on Transfer Pricing Audits.

11.5.1.7 Public consultation with business and stakeholders prior to implementation or modification of legislation, regulations or guidance material may help create more common understanding between the taxpayer and the tax administration. This will help to likely reduce potential future disputes by allowing time for taxpayers to foretell the issues that might cause greatest concern.

11.5.1.8 Use of information and communication technology (ICT) is a central feature in the delivery of tax administration services. Tax administrations should consider use of ICT to increase transparency in the tax system and to automate processes. An increase in transparency means making information more readily available, without the need for personal contact. An automated communications system can provide relevant internal stakeholders with online access to templates, case studies, step-by-step guides, explanations of legislative changes and relevant information geared towards specific industries or types of taxpayers. Automation of processes could include introduction or extension of electronic filing of transfer pricing related compliance obligations, and possibly the use of trusted third-party platforms. These measures have the potential to significantly reduce business compliance costs, improve taxpayer confidence and increase simplicity; they may also support anti-corruption initiatives and improve perceptions.

11.5.2 Establishing Transfer Pricing Capability: Possible Structures

11.5.2.1 There are two basic types of structures that can be adopted for establishing transfer pricing capability: a centralized model, with a single transfer pricing unit operating across all industries and geographical areas, or a decentralized model, with separate transfer pricing units by industry or geography. Each has advantages and disadvantages, as follows.

11.5.2.2 A **centralized model** presents the following advantages and disadvantages:

- *Advantages:* coordination and adjustments to the transfer pricing approach are made easier in the start-up phase; knowledge is built up more quickly; the model is aligned with a centralizing tendency in tax administrations (driven in part by the desire for all-encompassing technological developments and compliance strategies); there are clearer lines of authority, communication and reporting within the unit; and communications with other areas tend to be more coordinated.
- *Disadvantages:* there is a risk of being in an "ivory tower"— out of touch with realities on the ground; and a risk that over-centralization may reduce transparency and create opportunities for mismanagement and corruption. As transfer pricing experts will need, in any case, to work with experts from outside that group, such as people with various auditing skills, and more general tax auditors with some transfer pricing experience, it is at the very least important to guard against such an "ivory tower" mentality (and against being perceived as such) and ensure frequent interactions and exchanges of ideas and even personnel between such groups.

11.5.2.3 A **decentralized model** presents the following advantages and disadvantages:

- *Advantages:* there are shorter lines of communication with tax inspectors; the model more easily allows for combined industry and transfer pricing knowledge; and facilitates a long-term broader dissemination of transfer pricing awareness.
- *Disadvantages:* there are risks that team members may lack a single vision and coordination since they need to cover all tax issues rather than focusing on transfer pricing. Such coordination problems may lead to inconsistencies, lack of experience sharing and issues "falling between gaps"; and some taxpayers

may take advantage of a lack of coordination by, for example, "picking and choosing" who they approach for rulings.

11.5.2.4 Whatever model is followed, it is important to have a clear and coordinated approach to transfer pricing issues and their possible solutions, especially as MNEs will generally be far more familiar with transfer pricing issues than individual tax officers in a start-up unit. It is impossible to immediately bring the tax administration to a high level of knowledge in all relevant areas, especially when having to deal with many different industries. Measures need to be put in place to ensure good working relations with tax officials who are experts in particular industries, and tax officials in the various regions where transfer pricing issues may arise, including by regular meetings and formal contact points on both sides. This will help ensure the best realistic capability is achieved as soon as possible in terms of educating taxpayers and the administration on transfer pricing; responding to taxpayer requests; identifying compliance issues and their links to other tax issues; and addressing those issues.

11.5.2.5 It is very important to bear in mind the taxpayer service aspect of the work: the taxpayer should be able to go to a "one-stop" contact point to deal with all issues relating to transfer pricing. That contact point should in turn be responsible for the internal coordination, rather than the taxpayer in effect being forced to act as coordinating agent for the administration. This also helps to promote broader consistency and coherence within the administration.

11.5.2.6 The benefit of a "one-stop" contact point is also one of the reasons why many administrations have LTOs, often with specific industry contact points, to handle relationships with MNEs and other large taxpayers, especially in key sectors of the economy such as resource extraction. These offices can respond in an integrated fashion to diverse issues across different subject areas (for example: income tax, VAT and resource royalties) as well as issues of particular importance for some taxpayers such as transfer pricing and thin capitalization. They usually have auditing, registration, tax accounting, collection and taxpayer service roles and are sometimes seen as especially useful when implementing new approaches, including major policy or administrative reforms such as self-assessment or computer modernization of the tax office as an "incubator" for change elsewhere.

11.5.2.7 In a monitoring and intelligence gathering sense, this sort of structural approach can also enable more proactive analysis and action to deal quickly with emerging issues, such as unexpected falls in revenue from key industries or segments. Such falls may merely reflect economic conditions but could, alternatively, reflect emerging compliance risks[109]. Finally, reform of the administration as a whole may be a long-term project, because of a systemic need for skill development or integrity issues that need to be remedied. For example, it is sometimes considered that assembling a well-functioning, trusted and skilled large taxpayer office is the quickest way of safeguarding and monitoring key sectors while preserving relationships with taxpayers. This experience may also provide lessons that can be applied to the reform of the administration more generally.

11.5.2.8 Many countries adopt a highly centralized model for their transfer pricing unit at start-up. This reflects the importance of coordination and uniform approaches at that time; it also recognizes that a transfer pricing unit is not designed to have a specific lifespan but rather will become a permanent part of the tax administration's structure. Several models can be used to take transfer pricing capability further after this start-up phase. It is possible to create teams for every region that can exclusively deal with transfer pricing cases, for example. National coordination is then achieved by ensuring team members from each region work together and discuss the latest developments in transfer pricing.

11.5.2.9 Another model is to make all corporate income tax inspectors responsible for transfer pricing cases. In that case it is sensible to appoint some regional focal points who have to be aware of all major issues and are responsible for ensuring linkages with policymakers.

11.5.2.10 As noted above, some countries also have a separate office dealing with large MNEs because of their specific characteristics, their relevance in terms of investment, the tax revenue they may generate, and the related tax issues that are of special importance. Such an office can be organized on a national level or within the regions, depending on the number of MNEs that are active in the country. As noted above, this unit should as far as possible act as a central contact point (or "one-stop shop") for responses on MNE issues and it will therefore need to contain transfer pricing expertise or at the very least work especially closely with the transfer pricing unit.

[109] UN (2017). *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (Second Edition). New York: UN Publishing. Available from https://www.un.org/esa/ffd/wp-content/uploads/2017/08/handbook-tax-base-second-edition.pdf

11.6 Building Team Capability

11.6.1 General Human Resource Management Issues

11.6.1.1 A new transfer pricing regime may often be created as part of major changes within a tax administration, such as recognition of the impact of globalization and international value chains in that particular country. As with most changes there are potential advantages and disadvantages. While the human resources management strategy for the unit needs to be integrated within that of the organization, there are aspects that are likely to be of particular relevance in this area, including the importance of:

- The unit's "culture", focusing on achieving the organizational vision, mission and objectives; motivating and providing incentives for performance; measurable goal setting; and mutually agreed and annually updated performance objectives and standards. In a new team, the importance of this work and of good team leaders should not be underestimated;
- Broadly trained officers who understand the importance of investment for a country's development (including the importance of avoiding double taxation) and understand the drivers and environment of business, yet believe not only in the crucial importance of collecting the country's appropriate tax take but also in the necessity of public confidence in the integrity of the system and in their actions as tax officials;
- Internationally focused officers (including those familiar with the languages most used by international business) who meet routine business needs but are proactive, creative and adaptive to new ideas and challenges, seeing change as an opportunity;
- Officers who are keen to develop and to explore the most efficient and effective ways of doing their work and are patient in dealing with the large demands, complexity and often slow progress of transfer pricing cases rather than seeking to "cut corners";
- A strategy for the identification and development of managers who are respected, have integrity and can motivate staff and help them share the vision of the unit and the organization;
- A strategy for recruiting and retaining appropriate technical leaders and team managers. This strategy can be furthered by discussions, rulings, meeting clients in teams and forming a database of experience—not to be used blindly, but to encourage consistent and appropriate ways of analyzing issues and reaching conclusions; and

- Clear career prospects and incentives (such as learning opportunities and secondments) for successful officers, based on performance assessments that are fair and objective, and reflecting the aims of the unit. This means that excellent taxpayer service should be rewarded, not merely activity that appears to be more directly revenue generating. In particular, there are clear dangers in incentives based mainly or wholly on the level of adjustments made, as this can encourage unjustified or inappropriate adjustments. In any case, it may take years to establish whether an adjustment was justified or not, perhaps long after the officer has moved on. Such unjustified adjustments are, in fact, counterproductive to the success of the unit in establishing confidence in the system and providing taxpayer service.

11.6.1.2 Practice has shown two particular human resources – related risks at this stage. First, there is the possibility of resentment against those involved with transfer pricing policy and administration by others in more "established" areas. Because it is new, people within the organization do not always know exactly what it is about and feel uncertain. They can be unwilling or dismissive about taking up transfer pricing issues. Further, setting up a transfer pricing unit may require the recruitment of outside expertise in key roles. Existing staff may feel it is a "fashionable" area of work that draws resources and support away from their own equally important areas of work, or unduly rewards "outsiders" and "upstarts" who have not "paid their dues". The interrelationship and equal importance of different aspects of the organization's mission and vision need to be emphasized and "buy-in" established with other parts of the organization. However, it has to be stressed that building up capability in this area will involve new approaches and bringing in some fresh perspectives and new skill sets. The unit should not have a sense of superiority as part of its culture, but rather a sense of the importance of its work and of the opportunities to pursue broader organizational goals while furthering personal development.

11.6.1.3 The link can be established between an effective transfer pricing response and a more effective response by the organization to more general tax issues. Efforts can be made to have transfer pricing information and training sessions for officers elsewhere in the organization. This can reduce any impression that transfer pricing is a "black box" known only to members of the transfer pricing unit (or worse, that the unit and individual unit officers want to keep it that way) and can emphasize natural linkages to the other work of the administration, such as thin capitalization or treaty negotiation and administration. Conversely, training in how particular industries operate, especially ones that are important in a country, will greatly help increase the effectiveness and focus of transfer pricing experts.[110]

11.6.1.4 There is, on the other hand, a risk that employees from the tax administration will become overly enthusiastic about transfer pricing as a panacea and may, accordingly, propose unjustified or disproportionate tax adjustments leading to time consuming litigation or MAP. It is often stated that transfer pricing is not an exact science. That inexact quality can be abused by authorities as well as by taxpayers. It is thus important to manage this process, and ensure that any proposed transfer pricing adjustment is justified on purely transfer pricing grounds; it is also important to show that the discretion implicit in such an inexact situation is properly exercised. This involves integrity issues and it is important that decisions taken having a major financial impact are appropriately checked and "signed off" in a way that not only ensures (as far as possible) that they are made for the right reasons and consistently with the treatment of other taxpayers, but that they are also perceived as such.

11.6.2 Competences/Skill Sets Needed by the Unit: Putting Together the Best Team

11.6.2.1 Recognizing the many aspects of transfer pricing and that the unit will have educative and taxpayer service functions as well as an enforcement role, a transfer pricing unit should ideally include, or have ready access to, the following skill sets:

- Team and project managers—people with demonstrated ability to put together new teams, whether or not they have specific transfer pricing expertise;
- Economists;
- Lawyers;
- Accountants;
- Auditors;
- Database experts;
- Business process experts (using information technology to evaluate, automate, integrate, monitor and help improve business processes); and

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110 Readhead, A. (2016). *Preventing Tax Base Erosion in Africa: A Regional Study of Transfer Pricing Challenges in the Mining Sector.* New York: Natural Resources Governance Institute. Available from https://resourcegovernance.org/sites/default/files/documents/nrgi_transfer-pricing-study.pdf

- ➢ Those with special public relations and communication skills, including the ability to: listen actively and effectively, solve problems, explain complex issues in terms that are readily understandable and act "diplomatically" with a view to longer-term productive relationships. The increasing scrutiny of transfer pricing policy and administration in most countries makes this especially important.

11.6.2.2 These various skill sets should be bound together not just by technical knowledge and willingness to learn, but also by a common identification with the unit and wider administration's objectives and ways of doing business. In addition, a deep understanding of what drives business and how it organizes itself to meet its own objectives needs to be internalized in the unit's work. Having regular access to such skills is the ideal situation of course, and many countries with fairly new transfer pricing regimes have, of necessity, focussed initially on legal, economic, accounting, audit and database skills.[111]

11.6.2.3 Dealing with MNEs demands specific characteristics and competences. Transfer pricing is about how business operates and the application of complex tax laws and economic principles to those business operations. Knowledge of international taxation and good judgment is required to select the right areas to focus on and the right cases for an audit, as some transactions are more tax-driven than others. The ability to interpret information, and to sort the relevant from the irrelevant is becoming ever more important as opportunities to obtain information from other tax administrations and from MNEs themselves increases. Having information available but being unable to properly interpret it may put an administration in a worse position, especially before the courts, than not having access to information in the first place.

11.6.2.4 Staff with a background in accounting have often been regarded as easy to train in transfer pricing as they are often enthusiastic about specializing in this field, but similar enthusiasm can be found in those with other skill sets. Others, such as lawyers and economists have special skills in dealing with the often complex law and economics of transfer pricing cases, and one of the challenges in this area is having all those skills working together effectively.

11.6.2.5 At the initial stages, specific transfer pricing expertise may not be generally available in the country (or at least within the administration) and will in large part have to be developed. At a later stage expertise from outside

[111] Ibid, p. 24.

may be encouraged to join the tax administration by job gradings that reflect the scarcity of skills, and good salaries — perhaps higher than usual salaries, although that can create resentment among other staff. Other non-financial incentives may be important, such as the ability to work on the governmental "side", perhaps with greater policy or legislative exposure (including at an international level) and improved lifestyle (by creating a more balanced work environment for those with children, for example). Developed countries may be willing to place one of their experts in a developing country as a component of Official Development Assistance (ODA) or to sponsor a promising officer from a developing country in a placement within their administration.

11.6.2.6 One study noted the value of having embedded experts seconded from other countries (sometimes the same official a few times each year) who have confronted similar problems and developed pragmatic approaches to deal with them.[112] Such experts can share their experience and give auditors more confidence in demanding information from taxpayers.

11.6.2.7 A key challenge of working closely with taxpayers is that many of the best trained experts from the tax administration may eventually leave to join the private sector. This will have an effect on individual cases as well as on the operation of the unit more generally. As noted in more detail below, a system designed to capture and spread knowledge of transfer pricing issues within the unit, which includes team involvement, effective management, and regular review of cases, will help to minimize the effects of these departures, as will an effective system of recording and filing relevant transfer pricing opinions and material relating to particular cases. In any case, such interplay of "cultures" between the administration and the business sector over time can be useful for each of these entities; it helps each to understand what drives the other and what the expectations are.

11.6.2.8 In addition to technical expertise, "soft skills" are also important for officers to perform their duties. Negotiation and communication skills are essential since transfer pricing demands a great deal of interaction with MNEs. There will often be a range of possible outcomes in transfer pricing and room for discussion. Skills that help make these discussions as professional and effective as possible are an important component of a successful transfer pricing unit.

11.6.2.9 Integrity issues may arise from the close contacts between business and the tax administration, the large amounts of money often at stake, the fact that transfer pricing requires the exercise of discretion and judgment in

[112] Ibid, p. 25.

determining appropriate outcomes, and the fact that transfer pricing analysis often gives a range of results rather than a single clear answer. These issues can be exacerbated by a trend of many tax officials engaged in transfer pricing issues later moving to the private sector. The best way to deal with these issues is by having discussions with MNEs in teams and ensuring that records are kept of those discussions. The records should be internally reviewable to ensure that the proper policies and practices have been followed and to make sure a consistent approach has been adopted between taxpayers. This helps to ensure that working arrangements are transparent, open and incorporate built-in checks and balances that will reduce the risk of temptation on both sides. It is also important to recognize that officers should be given protection from false accusations against their integrity, which may reduce their willingness to approach each case fairly and impartially. The checks and balances should be designed to support officers acting properly and maintain the effectiveness of the unit. A way for officers to bring issues of integrity to management attention (through secure channels that will act on such intelligence without punishing the whistle-blower and discouraging such behaviour in future) should also be considered.

11.6.2.10 Regular internal audits of the members of the unit can form part of the system of checks and balances. These audits could include reviews of quality, consistency and timeliness of decisions as well as, possibly, of personal assets of individual officers (such as by declarations of assets and interests and checks as to their accuracy). If resources allow, some form of double-checking of audits including rotation of fresh auditors into such roles can prove to be useful in this respect.

11.6.2.11 A review process of important cases by a formal panel or informal reviews by a senior group is suggested as a way towards achieving coherence and consistency, adherence to administration rulings, integrity, sound technical standards and effective case management. This can also, to some extent, form part of the on-the-job training. Those undertaking the review should ideally comprise not just officers from the unit, but also from other relevant areas. The group could include officers dealing with the type of business or industry (such as officers from the large taxpayer office if it is separate), intelligence officers, officers from the economic unit (if there is a separate pool of economists working on transfer pricing issues but not part of the transfer pricing unit—an issue discussed below), tax treaty experts and those dealing with potentially related areas, such as thin capitalization. This need for checks and balances is likely to assume even greater importance, with greater scrutiny of transfer pricing issues by civil society and parliaments likely in most countries over the coming years.[113]

[113] Ibid, p. 36 et seq.

11.6.2.12 A well-functioning transfer pricing unit needs both legal and economic expertise. Transfer pricing knowledge is about pricing, economic rationale, market knowledge, and business and industry knowledge. It is, however, also important to understand international taxation issues and the tax rationale underlying relevant transactions.

11.6.2.13 There are sometimes questions as to whether a group with a specific professional specialization, such as economists, should be distributed within other teams or should comprise, at least in the start-up phase, a separate unit. Some of the same issues arise as in the set-up of a transfer pricing unit as a whole. The advantages of distributing economic expertise (as an example) more broadly are that economic issues are treated as just one aspect of the transfer pricing regime. As such, economics expertise is spread more broadly within the tax administration, and the economic perspectives are more easily integrated into the work of multidisciplinary teams.

11.6.2.14 The advantages of a separate pool of economists, on the other hand, are that greater "quality control" can be exerted, especially in the start-up phase, over the consistency of economic analyses. Further, economists in a new area can discuss new issues and learn from each other more easily. As with any specialist skill, having economists working in groups at the start-up phase may also be seen as promoting integrity and an "aligned" and consistent approach to the issues that arise.

11.6.2.15 Whichever approach is adopted, efforts will need to be put in place to ensure sufficient linkages and knowledge exchange between the "pool" of economists and other officials that will be part of multidisciplinary transfer pricing teams. It may also be a good idea to consider developing a separate pool of risk assessment officers.

11.6.3 Training

11.6.3.1 In some countries the educational system provides a steady supply of accountants, auditors, economists and lawyers from which the tax administration can draw. In other countries the situation is more difficult either because the formal educational system does not produce enough qualified graduates or because there is more competition, especially on salaries, from the private sector. This will affect the type of training required and it is of the utmost importance to assess the knowledge, capabilities and competencies of officers.

11.6.3.2 In developing what might be called a "learning plan" for the unit and its individual officers, it is recommended to first assess existing capabilities. This cannot be done without a context, and that context must be the short, medium and longer-term objectives of the unit, so it is essentially a "gap assessment". Such an assessment considers what needs to be done to go from the current capability to the desired future capability. It will address how to achieve the objectives at various stages of the life of the unit and under various scenarios.

11.6.3.3 This assessment should be followed by setting up a training programme to operationalize its recommendations. For a start it is good to first have a group of experts with accountancy and legal backgrounds. The pioneer group to be trained should consist of senior tax officials from the administration (and preferably also from the policymaking area). They are the pioneers and champions who should instil awareness in their colleagues of the importance of a transfer pricing capability. They will organize lectures and in-house seminars to train those officials who will become the next group of experts and to increase their skills and knowledge.

11.6.3.4 Specialist courses will be an important aspect of the training programme. As transfer pricing is a highly specialized field, in-country training from international experts and perhaps some training of experts overseas will be needed, with a plan to ensure they disseminate their new learning more broadly upon return (such as adopting a train-the-trainer approach). As with any training, it needs to be demand-driven, to respond to the needs of the transfer pricing unit, to speak to their current level of understanding and take it forward and ensure commitment. Demand-driven training also requires that those demanding the training are made aware of the opportunities for improving their capabilities and performance (as well as job satisfaction) by undertaking targeted training. International development agencies, regional tax administration groupings, international organizations and training institutions may be willing to assist with this.

11.6.3.5 The next step is to expand this transfer pricing knowledge and expertise. A possible model is to train several employees, who are given the appropriate level of authority, in each region with the right skills and make them responsible for further training as well as operational activities. However, the disadvantage is that other tax officials may resent this group, especially if they are given financial and non-financial incentives, as sometimes happens. In this initial period, it is expected that only a few cases will be dealt with; but transfer pricing experience is nonetheless being developed. These specialists should meet with policymakers to share the latest developments and discuss what is happening in other countries. The policymakers will see what the major issues are and have early warning of issues on the horizon that may need swift but considered policy responses.

11.6.3.6 In the meantime, the same approach can be adopted to train the next generation of specialists. The ultimate aim is that all corporate income tax specialists are able to handle at least some aspects of transfer pricing cases. Before that is achieved, as large as possible a group of those dealing with MNEs needs to be able to at least *identify* cases where there is a transfer pricing issue, for further consideration by specialist transfer pricing experts. Even though they may not know all the answers, they will be able to identify issues and will know where to go to find the answers. Additionally, their involvement in this process will help enhance their knowledge.

11.6.3.7 Training should not be merely on transfer pricing issues, of course, as expertise in how a particular industry operates, including the value chains it utilizes, can be especially important if a transfer pricing expert operates predominantly in relation to that industry.[114] Training in management, negotiation and inter-personal/relationship building skills will also be very important. So too will be knowledge management, project planning, database and other IT skills. Ethics training can be helpful in ensuring that officers are aware of ethical considerations in their new role as well as more formal legal rules of conduct, and of the way in which these interact (especially as to the exercise of discretion).

11.6.4 Research Materials/Databases

11.6.4.1 The unit should have access to basic transfer pricing books and, if finances allow, a subscription to a dedicated transfer pricing journal dealing with current issues of interest to countries. As noted elsewhere in this Manual, databases are used by administrations, taxpayers and their advisers when searching for and evaluating possible comparables. They can be used to analyze materials such as:

- Company annual reports;
- Auditor's reports;
- Profit and loss accounts;
- Notes to the accounts;
- Balance sheets;
- Materials indicating the nature of related party transactions;
- Materials indicating the nature of the business; and
- Materials indicating profit margins.

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[114] Ibid, p. 26.

11.6.4.2 Such databases can provide access to private company data not on the public record, as well as public company data. They can also be helpful in systematizing how the data is used, in keeping a record of what is looked at, who has looked at it, and what decisions have been taken as a result, in serving as a way of ensuring documents are readily accessible and searchable, in providing regular backups, and in providing a help-desk function that may have an educative role.

11.6.4.3 Private databases tend to be expensive, although sometimes an introductory price can be negotiated that is much lower than the usual pricing. It cannot of course be presumed that the low price will always be offered. One caution is that relevant data from companies operating locally are not available for many developing countries, and the relevance of databases based on other markets and environments has to be carefully considered — adjusting the data to be more relevant to your cases may itself be very resource-intensive. That issue is addressed in more detail in Chapter 3 on Comparability Analysis.

11.6.4.4 Transfer pricing resources of all types tend to be expensive, and there should be a budget line for such materials in any proposal seeking donor assistance for setting up a transfer pricing regime. The PCT Transfer Pricing Toolkit considers some of the issues involved in the use of databases, especially in adjusting comparables from other markets, and some of the skill sets needed (see 2.5.3.2).

11.6.5 Information Strategies

11.6.5.1 The unit will need to have access to the necessary information technology hardware and software to enable them to deal with the complexity and volume of transfer pricing-related information, with necessary security measures in view of the commercially sensitive taxpayer information that will be held.

11.6.5.2 Information strategies will be needed to deal with such technology and the way information is held. Taxpayer files need to be held securely but centrally, so that it is clear what has been requested of taxpayers and when, as well as what has been received and when. It should also be clear when materials have been accessed and by whom among the authorized persons, as well as whether information has been downloaded. A data back-up policy will be needed, with measures to ensure that no data are lost if there is a corrupted or lost back-up (such as duplicate backups held in different locations, with the immediately previous backups being retained also). It is important that documents are not lost or destroyed and that the large volume of paperwork that is a characteristic of transfer pricing cases is not overwhelming, but is securely held. The possibility of litigation on transfer pricing issues must always be borne in mind, even though it should be seen by both sides as a last resort.

11.6.5.3 Some countries require material to be provided in electronic form, and others require or encourage an index system for the documents provided and a description of the record-keeping system used. If such information is electronically searchable then, subject to the availability of the necessary software and skills, there are potentially great resource savings in dealing with often very large files, speedier response times, and less chance of information being lost. The cost to taxpayers of providing material in certain forms should always be considered in deciding what should be required under relevant legislation or regulations.

11.7 Effective and Efficient Business Processes

11.7.1 Streamlining and simplification of procedures is part of tax administration reform to reduce compliance costs for taxpayers as well as collection costs for administrations. Any such processes being considered in a country should be internalized as part of setting up any transfer pricing capability. This is especially the case because overcomplicated procedures can lead to more informal processes, short-cuts or discretions being used with no legal basis and/or with inconsistency in application between taxpayers. They thus create a severe risk to the integrity of the system as well as increasing compliance and collection costs.

11.7.2 A useful approach is to consider what other administrations do in similar circumstances, especially administrations in the same region, and to follow that guidance unless there are reasons why such guidance is not appropriate after a close examination of the options and the engagement of stakeholders. This approach of looking to what is being done elsewhere as a first point of reference will reduce compliance costs for taxpayers and contribute to a positive investment climate without impacting on the ability to deal with enforcement issues. In fact, it should enhance that ability, as the user can draw upon the practice of other administrations and probably deal with those administrations more effectively because of common starting points.

11.7.3 There will generally be discretion provided in the legislation or regulations of the transfer pricing regime in any case. Such discretion represents a trade-off between a flexible system that takes account of particular circumstances and recognizes the inherent scope for differences in transfer pricing analysis, on the one hand, and the risk that discretion will be exercised inconsistently across similar cases (thus favouring one taxpayer over another) or may raise integrity issues, on the other. Clear guidance for the exercise of discretion and a system of oversight will be needed.

11.7.4 Owing to the amounts of money at stake in many transfer pricing cases, and perhaps the fact that government transfer pricing experts often eventually leave for the private sector, strong checks and balances are required when decisions are made affecting taxpayer liabilities to tax. Conversely, it needs to be clear that the unit is not anti-business, but recognizes the way business operates, the need to follow the law, as well as the need to recognize the duty to provide service to taxpayers and exercise strong enforcement approaches only where warranted and on a fair basis.

11.8 Application of the Above Considerations in Implementation

11.8.1 Drawing upon the factors discussed above, the start-up phase of pricing operations of a Transfer Pricing Unit requires:

- ➢ A critical look at the availability of human resources within the tax administration. Prioritization is essential and choices have to be made concerning the attention to be given to different kinds of taxes. A policy on transfer pricing without sufficient resources being available to the tax administration implementing it "on the ground" will not achieve its objective;
- ➢ Understanding of the country's economic characteristics. It will be useful to look for statistics on trading volumes and other indicators for cross-border transactions. In a start-up phase many countries focus on their main industries (such as mining, pharmaceuticals, telecommunications, breweries and automobiles, and usually on the larger players in those industries in particular;
- ➢ Good, professional relations with business. Acceptance and understanding of the policy will reduce compliance and collection costs. Meetings with all stakeholders will help in effectively building and improving transfer pricing policy and capability. This also means non-compliance is less likely to be due to honest misunderstandings of the regime's requirements, and that there is more current intelligence on existing and emerging issues. This allows more focussed and efficient guidance and enforcement action;
- ➢ Understanding what other countries have done at a similar stage, what they are doing now and where that represents an evolution.

This can include:

- Inviting representatives from other countries with a history of transfer pricing to give their views and share their experiences;
- Reciprocal placements with countries that offer useful experience and are willing to assist can be an excellent way to learn. It will be necessary to first prepare a clear plan of what knowledge is being sought, why the other country willing to host a visit is the right country to learn from, and the expected impact and flow-on effects;
- Seeking support from donors to arrange visits to such countries, with rigorous and strategic selection of participants, a strong work programme and an obligation to report on the outcomes and lessons learned. All this will help to ensure that a visit is not perceived, including by the other country or potential donors, as a "holiday" for participants. This can have important additional benefits in personnel management as those who are most open to learning new things and are judged likely to stay with the organization for some time and take transfer pricing technical or managerial leadership roles may be offered such exposure; and
- Exploring the training assistance available from international organizations including the UN, the OECD, the World Bank Group, the IMF, and regional organizations such as ATAF and CIAT.

- An ability to define, with policymakers and administrators involved in the process, the important areas of focus bearing in mind:
  - The main characteristics of the country's industries, e.g. manufacturers or distribution activities;
  - The main kinds of cases contained in the workload of the tax administration;
  - The main types of activities to start with in developing policies, recognizing the need for policy to be soundly based in reality; and
  - Practical case studies that can provide input for policymaking and a focus for discussing administration issues.

11.8.2 After starting the transfer pricing unit, areas of focus will evolve depending on factors including the stage of development of the transfer pricing policy and the administration. In the first years it is often considered helpful to focus on less complicated activities such as contract manufacturing, intragroup services etc. When a higher level of experience is reached, the focus will often shift to more complex and challenging areas such as intangibles and business restructurings. The same journey has been undertaken by developed countries. However, this does not mean that particularly blatant examples of mispricing in these more complex areas should not be addressed at an early stage.

11.9 Assessing Effectiveness and Fine Tuning

11.9.1 It is best to set up a system of monitoring based on a performance measurement framework that establishes key performance indicators and outputs. While it is important not to overload staff, who will undoubtedly be very stretched for time and resources, with too much paperwork, possible areas of monitoring (some by raw data, some by questionnaires and interviews) include:

- The time schedules involved in transfer pricing disputes;
- Yield from risk-based audits and the percentage of yielding audits;
- Adjustments in tax assessment;
- Ability to respond quickly to emerging issues—including measurable deterrent effects on taxpayer behaviours;
- The number of Mutual Agreement Procedures (MAPs);
- Effectiveness of education campaigns and ongoing contact with business groups and their advisers, as well as evidence such as increasing traffic to the website;
- Percentage of correspondence and telephone calls dealt with according to previously established customer service standards;
- Total administration costs of the unit as a percentage of gross collection;
- Improvements made to process, as well as legislative improvements that have arisen out of the areas of work;
- Training undertaken and given, and the measurable impact; and
- Evidence of sharing best practice with other government departments and other tax authorities as part of a continuous improvement strategy.

11.9.2 As with any such measurement process, if data that is collected is not being used by management to assess progress the reasons should be considered, and the data requirements modified, or the use of the data improved. In other words, the process of review should itself be reviewed for effectiveness on a regular basis.

11.10 Country Examples of Capacity-Building in Transfer Pricing

11.10.1 **Japan** started its transfer pricing administration with a small unit in the late 1980s. Once the National Tax Agency (NTA) identified the rapidly increasing needs for transfer pricing management it expanded a nationwide training course for international taxation step-by-step, now reaching approximately 100 trainees every year; and also reorganized and gradually expanded the national and regional examination division. Currently the headquarters has transfer pricing sections and the MAP office, while the four major regional bureaux have special divisions for transfer pricing (including two divisions specializing in APAs). Although some essential documentation concerning transfer pricing is required by statute to be translated into Japanese, transfer pricing specialists are generally equipped with sufficient language skills to conduct examinations of the original accounting books, documents etc. in English.

11.10.2 In **India** capacity-building has taken place mainly through on-the-job-training. The Directorate of Transfer Pricing has expanded given that the numbers of cases being referred for audit are increasing annually since 2004, when the Directorate was set up. The National Academy of Direct Taxes, the apex body responsible for training, conducts specialized training for officers. The Directorate has organized seminars and conferences for experience-sharing by officers engaged in audit and for capacity-building of officers joining the Directorate.

11.10.3 In **Malaysia**, the Inland Revenue Board Malaysia (IRBM) responded to the rise in issues pertaining to cross-border related party transactions in audit and investigation cases by setting up the transfer pricing audit unit, known as the Special Audit Unit, on 1 August 2003.

11.10.4 The unit began operations with five officers based in the IRBM headquarters, reporting to the Director of the Compliance Department. From 2004 to 2009 IRBM also had two auditors based in each of the Penang and Johor state offices to deal with transfer pricing cases with the assistance of the Special Audit Unit. By 2007, transfer pricing cases had become increasingly challenging and the Special Audit Unit had grown to 12; however, it was found that transfer pricing issues were still being taken up by other branches resulting in lack of uniformity in the methods used to settle cases. IRBM then decided that transfer pricing audit activity needed to be centralized in order to increase officers' expertise as well as to ensure a standardized approach.

11.10.5 The IRBM Multinational Tax Department came into existence with the introduction of transfer pricing regulations under Section 140A and Section 138C of the Income Tax Act 1967 which came into effect on 1 January 2009. In 2008, measures towards centralizing transfer pricing activities were proposed and eventually came into force on 1 March 2009 when the unit was spun off from the Compliance Department into a department of its own. The Multinational Tax Department, headed by a senior director, now reports directly to the Deputy Director General of Compliance. The department is still relatively small, as the intention behind the set-up is to build expertise in a small group who will later be dispersed to provide assistance and knowledge to other branches within IRBM. In general, the Department has four divisions as follows, with individual division directors:

- Policy Division (one auditor), responsible for matters pertaining to regulations and procedures;
- Multinational Audit Division (eight auditors), which conducts audit visits;
- Compliance Audit Division (four auditors), which monitors compliance of cases previously audited; and
- Advance Pricing Arrangements Division (one auditor) which deals with the application and processing of APAs including bilateral and multilateral APAs.

11.10.6 Auditors were sent to various training events both inside and outside Malaysia from the initial set up of the Special Audit Unit. The Department continues to send auditors to various courses to increase knowledge and expertise in transfer pricing issues, as well as having the opportunity to share their own knowledge and experience within the transfer pricing community more generally.

11.10.7 In **Kenya**, whilst resourcing and skills challenges remain for the Kenya Revenue Authority (KRA), active measures have been taken to build capacity in its transfer pricing unit by equipping the unit with enough experienced staff with the required set of skills; capacity building through continuous training and re-tooling; maintaining staff motivation through recognition and promotions, international training and exposure; and retaining multi-skilled staff in the unit. The transfer pricing unit in Kenya has highly skilled transfer pricing teams with different specialists including lawyers, accountants, economists and business analysts to ensure an understanding of commercial operations.

11.10.8 The main challenge for Kenya in determining arm's length profits has been the lack of domestic comparables. There are no databases containing Kenya specific, or for that matter, Africa specific, comparable data. As a result, both the tax administration and taxpayers rely on European databases to establish arm's length levels of profitability. Challenges have been experienced in making adjustments for geographical differences or levels of country risk (for example, market, economic and political differences).

11.10.9 Building on the practice adopted in India and China, KRA is currently considering its approach to location savings, location specific advantages and market premiums within certain industries and those factors will be addressed when conducting audits.

12 Documentation

12.1 Introduction

12.1.1 Adequate transfer pricing documentation can serve several useful functions. Quality transfer pricing documentation will: (i) ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices for transactions between associated enterprises; (ii) provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment; and (iii) provide tax administrations with useful information in order to enable evaluation of a taxpayer's transfer pricing position upon audit, thereby contributing to the avoidance of disputes and to the timely resolution of any transfer pricing disputes that may arise.

12.1.2 The OECD/G20 BEPS Project created a more consistent and useful documentation standard for use by countries. Insofar as possible, countries should conform their transfer pricing documentation requirements to established international standards in order to limit compliance burdens imposed on taxpayers. When these international standards are followed, documentation will be characterized by (i) sufficient detail to demonstrate the taxpayer's compliance with the arm's length principle, and (ii) the timely delivery of such useful information to tax authorities, enabling them to assess tax risks and begin audit investigations in appropriate cases. A taxpayer should make reasonable efforts to reflect in its documentation an adequate transfer pricing analysis of its material transactions with associated enterprises in order to establish its good faith effort to apply the arm's length principle.

12.1.3 This chapter first summarizes recent developments regarding the establishment of international guidelines on transfer pricing documentation. It then provides a more in-depth discussion on several topical issues that developing countries will need to address in adapting the international standards to their own needs. The chapter provides practical guidance on transfer pricing documentation related issues.

12.2 International Guidelines on Transfer Pricing Documentation

12.2.1 OECD/G20 Transfer Pricing Documentation Standard

12.2.1.1 The OECD first published guidance on transfer pricing documentation in 1995, shortly after the first individual country rules on documentation were developed. The original OECD Transfer Pricing Guidelines contained general principles but did not prescribe a list of specific items to be included in transfer pricing documentation. Numerous countries have adopted transfer pricing documentation rules and gained experience administering those rules since then. Several multinational bodies also sought to develop consistent transfer pricing documentation standards. Notwithstanding these efforts by multinational bodies to encourage consistency, the various country rules differ from one another in many ways, a fact which complicates taxpayer compliance with global documentation requirements. Accordingly, in 2015, in connection with the OECD/G20 BEPS Project, the OECD guidance on transfer pricing documentation was updated to establish a uniform documentation standard.[115]

12.2.1.2 The OECD/G20 BEPS Final Report on Action 13 (2015) guidance sets out a standardized three-tiered approach to transfer pricing documentation. It suggests that documentation should include: (i) a **master file** containing general information about the MNE relevant to all MNE members; (ii) a **local file** referring specifically to material transactions of the MNE members resident in the local jurisdiction and setting out the taxpayer's transfer pricing methodology for such material transactions; and (iii) a **country-by-country report** ("CbC Report") containing certain information relating to the global allocation among taxing jurisdictions of the MNE's income and taxes paid, together with certain general indicators of the location of economic activity within the MNE. The Final Report on Action 13 also includes agreed guidance on implementing the new documentation and reporting rules. The OECD work builds on earlier work of other bodies, particularly that of the EU.

12.2.1.3 **Master File.** The master file is intended to provide a high-level overview of the MNE's global operations. The new OECD/G20 documentation standard calls for the following information to be included in the master file:

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[115] OECD (2015). *OECD/G20 Base Erosion and Profit Shifting Project: Transfer Pricing Documentation and Country-by-Country Reporting: Action 13.* Paris: OECD Publishing. Available from https://www.oecd.org/ctp/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report-9789264241480-en.htm.

- ➢ A chart illustrating the MNE's legal and ownership structure and the geographical location of operating entities.
- ➢ A general description of the MNE's business including:
  - (a) Important drivers of business profit;
  - (b) A description (which may be in the form of a chart) of the supply chain for the group's five largest products and/or service offerings by turnover and any other products or services amounting to more than 5 per cent of group turnover;
  - (c) A list and brief description of important service arrangements between members of the MNE, other than research and development (R&D) services, including a description of the principal locations providing important services and the transfer pricing policies for allocating service costs and determining prices for intragroup services;
  - (d) A description of the main geographic markets for the group's products and services referred to in (b), above;
  - (e) A brief written functional analysis describing the principal contributions to value creation by individual entities within the group; and
  - (f) A description of important business restructuring transactions, acquisitions and divestitures occurring during the fiscal year.
- ➢ A description of the MNE's intangibles, including:
  - (a) A general description of the MNE's overall strategy for the development, ownership and exploitation of intangibles, including the location of principal R&D facilities and the location of R&D management;
  - (b) a list of intangibles of the MNE that are important for transfer pricing purposes and an indication of which entities own those intangibles;
  - (c) A list of important agreements among identified associated enterprises related to intangibles, including cost contribution arrangements, principal R&D service arrangements, and licence arrangements;
  - (d) a general description of the group's transfer pricing policies related to R&D and intangibles; and
  - (e) A general description of transfers of interests in intangibles among associated enterprises during the fiscal year, including the entities, countries and compensation involved.

- A description of the MNE's inter-company financial arrangements, including:
  - (a) A general description of how the group is financed, including important financing arrangements with unrelated lenders;
  - (b) The identification of any members of the MNE that provide a central financing function for the group, including the country under whose laws each entity is organized and its place of effective management; and
  - (c) A general description of the MNE's transfer pricing policies related to financing arrangements between associated enterprises.
- The MNE's annual consolidated financial statement for the fiscal year if otherwise prepared for financial reporting, regulatory, internal management, tax or other purposes.
- A list and brief description of the MNE's existing unilateral advance pricing agreements and other tax rulings relating to the allocation of income among countries.

12.2.1.4 **Local File.** The new OECD/G20 documentation standard suggests that the local file should contain the following information:

- A description of the entity or entities in the MNE that operate in the local country, including:
  - (a) A description of the management structure of the local entity, a local organization chart and a description of the individuals to whom local management reports and the country where their offices are located;
  - (b) A detailed description of the business and business strategy pursued by the local entity including a description of recent business restructurings or intangibles transfers in the present or previous year involving the local entity and an explanation of aspects affecting the local entity; and
  - (c) A description of key competitors of the local entity.
- Information related to material controlled transactions involving the local entity, including:
  - (a) A description of the transaction and the context in which it takes place;
  - (b) The amount of inter-company payments or receipts for each category of controlled transactions involving the local entity,

broken down by tax jurisdiction of the foreign payor or recipient;

(c) Identification of the associated enterprises involved in each category of controlled transaction and how they are related;

(d) Copies of all material agreements concluded by the local entity;

(e) A detailed comparability and functional analysis of the taxpayer and the relevant associated enterprises with respect to each documented category of controlled transactions including changes from prior years;

(f) An indication of the most appropriate transfer pricing method with regard to the category of transaction and the reasons for selecting that method;

(g) An indication of which associated enterprise is selected as the tested party, if applicable, with an explanation of the reasons that enterprise is selected;

(h) A summary of the important assumptions made in applying the transfer pricing methodology;

(i) An explanation of the reasons for using a multi-year analysis if relevant;

(j) A list and description of selected comparable uncontrolled transactions, if any, and information on relevant financial indicators for independent enterprises used in the transfer pricing analysis including a description of the comparable search methodology and the source of the information;

(k) A description of any comparability adjustments performed;

(l) A description of the reasons for concluding that relevant transactions were priced on an arm's length basis based on the application of the selected transfer pricing method;

(m) A summary of the financial information used in applying the transfer pricing methodology; and

(n) A copy of existing unilateral and bilateral/multilateral APAs and other tax rulings to which the local tax jurisdiction is not a party, and which are related to the controlled transactions being analyzed.

➢ Relevant financial information, including:

(a) Annual local entity financial accounts for the year concerned;

(b) Information and allocation schedules showing how the financial data used in the transfer pricing analysis may be tied to the annual financial statements; and

(c) Summary schedules of relevant financial data for comparables used in the analysis and the sources from which that information was derived.

12.2.1.5 **CbC Report.** The CbC Report is intended to provide a general overview of the allocation of the MNE's global income and taxes paid among countries. It is intended to be used for the purpose of assessing transfer pricing and other tax risks. The OECD/G20 BEPS guidance contains a template for the CbC Report. On the first page of the template, the MNE is required to report on a jurisdiction-by-jurisdiction basis for constituent entities resident in the relevant jurisdiction:

- ➢ Total revenue, broken down into unrelated party revenue and related party revenue;
- ➢ Profit (loss) before income tax;
- ➢ Income tax paid (on a cash basis);
- ➢ Income tax accrued for the current year;
- ➢ Stated capital;
- ➢ Accumulated earnings;
- ➢ Number of employees; and
- ➢ Tangible assets other than cash and cash equivalents.

On the second page of the template, the MNE should report, on a jurisdiction-by-jurisdiction basis:

- ➢ Each constituent entity in the group that is resident in the jurisdiction;
- ➢ The jurisdiction of organization or incorporation for each constituent entity if different from the jurisdiction of residence; and
- ➢ The main business activities for each constituent entity of the MNE.

12.2.1.6 In addition to prescribing standardized content for the master file, local file and the CbC Report, the OECD/G20 BEPS guidance addresses several important implementation issues.[116]

- ➢ It is recommended in the Final Report on Action 13 that the master file and local file elements of the documentation package

[116] Ibid. Annex IV.

be implemented through local country legislation or administrative procedures, and that the master file and local file be filed directly by the taxpayer with the local tax administration in each relevant jurisdiction;

- It is recommended in the Final Report on Action 13 that the CbC Report be filed with the jurisdiction of the parent company of the MNE and shared by that country with other interested countries through automatic exchange of information under the Multinational Convention on Mutual Assistance in Tax Matters, under bilateral tax treaties, or under Tax Information Exchange Agreements (TIEAs). It is recognized, however, that backup local filing requirements may be necessary in situations where the country of the parent company does not adopt the CbC filing requirement or where other specified circumstances make it impossible for the local jurisdiction to gain access to the CbC Report through treaty exchange mechanisms. Accordingly, if developing countries are to have access to the CbC Report, they will need to either join the Multilateral Convention on Mutual Assistance in Tax Matters or develop an extensive set of bilateral tax treaties and/or TIEAs that provide a basis for automatic exchange of CbC Reports filed in parent company jurisdictions. Under either of these alternatives, countries should also develop mechanisms for enforcing backup local filing rules in situations where MNE members operating in their jurisdictions may not have ready access to all of the global MNE data contained in the CbC Report to which the tax administrations are entitled. Model competent authority agreements have been drafted to implement the exchange of CbC Reports and numerous countries have already adopted the implementing agreement under the Multilateral Convention. It is expected that most countries will opt to join the Multilateral Convention;[117]
- It is recognized that important confidentiality concerns arise in connection with the CbC Report. Tax administrations should take all necessary steps to ensure that there is no public

[117] The OECD guidance on CbC reporting that has been published since the completion of the BEPS Action 13 Report contains detailed suggestions on the filing of CbC Reports, the sharing of those reports between relevant countries, the necessity of maintaining the confidentiality of CbC Reports obtained through information exchange procedures, and the appropriate use to be made of the CbC Reports. This guidance is contained in the documents described in paras. 12.2.1.7 and 12.2.1.8.

disclosure of confidential information contained in the CbC Report or other elements of the transfer pricing documentation package, including adopting appropriate legal measures to protect confidentiality. Protection of confidentiality is one of the principal reasons that countries agreed to use treaty exchange mechanisms as the primary sharing mechanism for the CbC Report;

- It is recognized that the CbC Report will be helpful for high level transfer pricing risk assessment purposes. It may also be used by tax administrations in evaluating other BEPS related risks and, where appropriate, for economic and statistical analysis. However, the information in the CbC Report should not be used as a substitute for a transfer pricing analysis of individual transactions and prices based on a functional analysis and a comparability analysis. The information in the CbC Report on its own does not constitute conclusive evidence that transfer prices are or are not appropriate. The CbC Report should not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income. Countries participating in the BEPS project commit that if such formulary apportionment adjustments are proposed based on CbC Report data, they will promptly concede the adjustment in any relevant competent authority proceeding. However, this does not imply that jurisdictions would be prevented from using the CbC Report data as a basis for making further enquiries into the MNE's transfer pricing arrangements or into other tax matters in the course of a tax audit;
- It is recommended that only MNEs with annual consolidated revenue of at least EUR 750 million (or an equivalent amount stated in local currency using January 2015 exchange rates) be required to file the CbC Report;
- Jurisdictions should utilize the standard template set out in the Final Report on Action 13 for the CbC Report, not requiring either more or less information to be reported;
- It was agreed that all aspects of the CbC Report, including its content and its implementation by taxpayers and tax authorities, would be reviewed again in 2020 after some experience is gained in preparing and using the CbC Report. In early 2020 the OECD released a list of questions that will be examined in this review and requested information from interested persons regarding those questions; and

- The OECD/G20 work has also included the issue of high-level technology standards for the format of CbC Reports to facilitate the exchange of such reports.[118]

12.2.1.7 Since the publication of the Final Report on Action 13, the OECD has, from time to time, published guidance on implementing the new CbC reporting regime. This Guidance is contained primarily in two useful publications. These are (i) *Country-by-Country Reporting: Handbook on Effective Implementation*, published in September 2017[119] and (ii) *Guidance on the Implementation of Country-by-Country Reporting: BEPS Action 13*, published in December 2019.[120] These documents provide detailed suggestions to countries adopting a CbC reporting requirement and to taxpayers seeking to comply with the requirement.

12.2.1.8 The guidance contained in these two documents addresses a variety of topics including transitional filing options for MNEs, notification requirements for MNEs during the transitional phase, the consequences of non-compliance with the confidentiality, appropriate use, and consistency requirements by countries and taxpayers, appropriate implementation of local filing requirements, the treatment of partnerships, investment funds and other special entities, the aggregation of data within a particular country, the treatment of dividends for purposes of the CbC filing thresholds, and numerous other questions.

12.2.1.9 The documents also provide technical guidance for governments on steps that can be taken to implement and simplify the filing and exchange between governments of CbC Reports and provide detailed suggestions for training of relevant government personnel on a multilateral basis. An important point contained in the implementing guidance is that the CbC regime is premised on the use of company accounting data and that accounting conventions used by taxpayers will therefore be followed in resolving most detailed reporting questions.

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[118] OECD (2016). *Country-by-country Reporting XML Schema: User Guide for Tax Administrations and Taxpayers*. Paris: OECD Publishing. Available from https://www.oecd.org/tax/country-by-country-reporting-xml-schema-user-guide-for-tax-administrations.htm

[119] OECD (2017). *Country-by-Country Reporting: Handbook on Effective Implementation*. Paris: OECD Publishing. Available from www.oecd.org/tax/beps/country-by-country-reporting-handbook-on-effective-implementation.pdf

[120] OECD (2019). *Guidance on the Implementation of Country-by-Country Reporting —BEPS Action 13*. Paris: OECD Publishing. Available from https://www.oecd.org/tax/beps/guidance-on-country-by-country-reporting-beps-action-13.htm

12.2.1.10 For developing countries, the implementation guidance contains useful instruction on complying with confidentiality requirements, reporting breaches of the rules on appropriate use of CbC Report data, the possibility of suspending the exchange of CbC Reports following consultation where proper use requirements have been violated, the resolution of cases where adjustments are inappropriately based on CbC report data, the technology schema to be used in sharing and receiving CbC Reports through exchange of information processes, and other important topics related to the exchange of CbC Reports between country tax administrations.

12.2.2 Implementation of Global Documentation Standards in Developing Countries

12.2.2.1 The international guidelines above were designed by the countries involved in the BEPS Project for adoption by them in the context of their own transfer pricing legislation, priorities, capabilities and experience. It cannot automatically be assumed that these OECD/G20 guidelines should be adopted in their entirety by every developing country. It is therefore important to examine these guidelines from the perspective of how they may work in practice in a developing country context, bearing in mind the administrative constraints that may exist in the tax administration and the MNE. In considering these OECD/G20 guidelines, however, all countries should also consider the great benefit of having consistent documentation rules from country to country to minimize transfer pricing compliance burdens.

12.2.2.2 Developing countries can assume that, in the future, MNEs will prepare the master file and that large MNEs will prepare the CbC Report. Requiring these documents to be delivered to the local tax administration in a developing country should therefore impose no marginal compliance burden on the MNE. The important question for developing countries, therefore, will likely be whether the local file envisioned by the OECD/G20 guidance should be adopted without modification in the local country.

12.2.2.3 The international standards are not self-executing. As noted above, local laws and/or administrative requirements must be adopted in each country to require local filing of the master file and local file. As many developing countries are engaged in a modernization process for their tax administrations, including in most cases significant investments in automation, countries can consider what new technologies are available in this regard to minimize compliance costs for both tax administrations and taxpayers.

12.2.2.4 Not all transactions that occur between associated enterprises are sufficiently material to require full documentation in the local file. Individual country transfer pricing documentation requirements based on the OECD/G20 guidance on the content of the local file should include specific materiality thresholds that take into account the size and the nature of the local economy, the importance of the MNE in that economy, and the size and nature of local operating entities, as well as the overall size and nature of the MNE. Measures of materiality may be considered in relative terms (e.g. transactions not exceeding a percentage of revenue or a percentage of cost measure) or in absolute amount terms (e.g. transactions not exceeding a certain fixed amount). Individual countries should establish their own objective materiality standards for local file purposes based on local conditions. As discussed in greater detail below, consideration should also be given to rules that exempt small or medium-sized enterprises from documentation requirements or that limit the extent of the documentation to be provided by such entities.

12.2.2.5 Similarly, in setting out local law requirements related to the master file, it should be recognized that taxpayers should use prudent business judgment in determining the appropriate level of detail for the information to be supplied. It should be kept in mind that the purpose of the master file is to provide tax administrations with a high-level overview of the MNE's global operations and policies. Information should be considered important if its omission would affect the reliability of the transfer pricing outcomes.

12.2.2.6 The CbC Report is likely to be delivered to the local jurisdiction of the MNE's parent company and to be forwarded to developing countries under treaty exchange mechanisms. However, as noted above, developing countries may need to adopt the Multilateral Convention on Mutual Assistance in Tax Matters or expand their networks of bilateral tax treaties and TIEAs in order to get access to the CbC Reports. The implementation materials in the Final Report on Action 13 contain model legislation and competent authority agreements that can be tailored to local country needs in adopting the CbC reporting requirement. Substantial detailed guidance on implementing the CbC reporting regime has been developed and published in the documents referenced at 12.2.1.7 and 12.2.1.8, above, and should be considered by developing countries as they implement CbC reporting.

12.2.2.7 In considering the implementation of documentation rules, developing countries could decide to use a disclosure form as an alternative to the list of required documentation contained in the OECD/G20 description of the local file. If such a disclosure form is used as a substitute for the local file, it should strike a balance between taxpayer effort required and its usefulness for tax authorities to make a proper assessment. The form should only be completed in relation to inter-company transactions of significant size. See the discussion of materiality at 12.2.2.4 above. Completing the form (supplemented by the master file and CbC Report otherwise prepared by the taxpayer) could be sufficient to comply with initial documentation requirements. Under this approach a full detailed transfer pricing report may need to be produced only upon request, rather than being filed with the tax return in every case.

12.2.2.8 The compliance burden and compliance costs for MNEs may be reduced by utilizing such a form, without unduly compromising the information that is ultimately available to tax authorities. Forms used in Canada and Nigeria may be useful examples. If disclosure forms are to be used rather than the local file format, tax authorities may want to consider that, to the extent these disclosure forms can follow a consistent format (i.e. list the same information as that required in disclosure forms used by neighbouring countries where the taxpayer may conduct business activities), the taxpayer burden in preparing the forms might be reduced. This in turn may serve to help enhance taxpayer compliance.

12.3 Experiences of MNEs with International Guidelines on Documentation

12.3.1 The documentation compliance burden has increased significantly in the past twenty years with more and more countries introducing specific transfer pricing documentation requirements. In the year 2000, there were approximately 15 countries with specific transfer pricing documentation requirements, rising to almost 60 countries in 2012 with even more countries introducing new documentation rules since then. As noted, there is a risk that countries may introduce transfer pricing documentation requirements that differ significantly from country to country, resulting in a substantial increase in compliance costs for MNEs.

12.3.2 MNEs welcome initiatives to reduce the compliance burden and the related compliance costs by introducing standards of required information that are relevant for multiple countries. The above-mentioned international guidelines should help to harmonize rules so the preparation of documentation will not become a business in itself instead of a support to the MNE's business and global tax compliance.

12.3.3 A large number of transfer pricing reports are prepared annually at present, just to satisfy local requirements, e.g. country-specific nuances, local language, annual searches and increasing focus on local comparables. As many businesses do not undergo major changes and/or restructuring every year the added value of an annual transfer pricing report may be open to question. It is recommended that transfer pricing documentation be periodically reviewed in order to determine whether functional and economic analyses are still accurate and relevant, and to confirm the validity of the applied transfer pricing methodology. In general, the master file, the local file, and the country-by-country report should be reviewed and updated annually. It is recognized, however, that in many situations business descriptions, functional analyses and descriptions of comparables may not change significantly from year to year. In order to simplify compliance burdens on taxpayers the tax administration may determine, as long as operating conditions remain unchanged, that the searches in databases for comparables supporting part of the local file be updated every three years rather than annually. Financial data for the comparables should nonetheless be updated every year in order to apply the arm's length principle reliably.[121]

12.3.4 If more consistency can be achieved regarding the information required, MNEs may develop a system that retrieves (part of) this information automatically from their financial information systems, ultimately reducing their compliance costs significantly.

12.3.5 It is important that the documentation rules be broad enough to capture the reality of the related party transactions without being excessively burdensome on the mere chance that, though unlikely, a particular piece of information may be relevant.

12.4 Practical Guidance on Documentation Rules and Procedures

12.4.1 Burden of Proof

12.4.1.1 In a number of countries the tax administration bears the burden of proof with respect to tax assessments unless a tax law specifically provides otherwise. Generally, that means that taxpayers need not prove the correctness of their transfer pricing unless the tax administration challenges taxpayers with concrete and clear reasons for such challenges. For further information see Chapter 10.

12.4.1.2 However, if a country has a set of specific documentation rules in its tax law or regulations, it may be the case that the burden of proof for the transfer price at which a taxpayer transfers goods or services with

[121] OECD (2015). *OECD/G20 Base Erosion and Profit Shifting Project: Transfer Pricing Documentation and Country-by-Country Reporting: Action 13.* Paris: OECD Publishing. Available from https://www.oecd.org/ctp/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report-9789264241480-en.htm. Further guidance that was issued is available from https://www.oecd.org/tax/beps/guidance-on-country-by-country-reporting-beps-action-13.htm.

related parties falls on the taxpayer, unless the taxpayer is believed to have fulfilled the obligations imposed by such documentation rules. Even where the burden of proof rests on the tax administration, the tax administration might require the taxpayer to provide documentation about its transfer pricing, because without adequate documentation, the tax administration cannot assess the case properly. In some countries, where the taxpayer does not provide adequate documentation, there may be a shifting of the burden of proof in the manner of a rebuttable presumption in favour of the adjustment proposed by the tax administration.

12.4.1.3 In countries where the burden of proof generally lies with the taxpayer, the burden of proof may shift to the tax administration if a taxpayer presents to the tax administration (or a court) a reasonable argument and evidence to suggest that the transfer pricing was at arm's length. Further, in some countries with specific documentation rules, the burden of proof shifts to the tax administration if a taxpayer has reasonably complied with the documentation rules.

12.4.1.4 Developing countries should ensure that the relationships between documentation rules and the burden of proof are clear in their domestic law. The burden of proof should not be misused by the tax administration or taxpayers as a justification for making assertions that may be difficult to substantiate through an ordinary level of transfer pricing documentation. In other words, both the tax administration and the taxpayer should practice good faith through reasonable documentation that their determinations on transfer pricing are consistent with the arm's length principle regardless of where the burden of proof lies.

12.4.2 Time Frame to Produce Transfer Pricing Documentation

12.4.2.1 Countries have different timing requirements for production of transfer pricing documentation. Any requirement that requires preparation of documentation at the time of the transaction, at the time the tax return is filed, or at the beginning of an audit may be referred to as a "contemporaneous" documentation requirement. The Committee has refrained from using the word "contemporaneous" to describe documentation requirements in this chapter to avoid confusion, as timing rules differ from country to country. Countries should consider what timing requirements best suit their needs and are consistent with their administrative procedures. Types of documentation requirements in use around the world may involve one or more of the following:

- ➢ Prepare information at the time of the transactions, to be submitted at the time of filing the tax return;

- Prepare information at the time of the transactions, to be submitted upon request in case of an audit;
- Prepare information at the time of filing the tax return;
- Prepare information only if requested upon audit; or
- No documentation requirement.

12.4.2.2 Taxpayers, in some cases, establish transfer pricing documentation to demonstrate that they have made reasonable efforts to comply with the arm's length principle at the time their intragroup transactions were undertaken based on information that was reasonably available to them at that point (hereinafter referred to as the "arm's length price-setting" approach). Such information includes not only information on comparable transactions from previous years, but also information on economic and market changes that may have occurred between those previous years and the year of the controlled transaction. In many countries, however, taxpayers are required to test the actual outcome of their controlled transactions to demonstrate that the conditions of these transactions were consistent with the arm's length principle, hereinafter called "the arm's length outcome-testing" approach. Such tests typically take place as part of the process for establishing the tax return at the end of a tax year. See 3.6.2 for a detailed discussion of this area. See also OECD TPG, paragraphs 3.69 to 3.71.

12.4.2.3 A country that wishes to establish a transfer pricing documentation rule should take into account the existence of the two pricing approaches mentioned above. Whether the arm's length price-setting or outcome-testing approach is used, data for external comparables may not be readily available at the time of the analysis.

12.4.2.4 The OECD/G20 documentation standards do not mandate specific rules regarding the time at which documentation should be prepared or presented to the tax authorities.[122] The guidance contained in the Final Report on Action 13 suggests that the CbC Report be completed one year

[122] Ultimately issues regarding the storage of relevant documents may depend on domestic law. Most countries may require taxpayers to keep documentation in paper format. However, depending on the development status of a country's electronic technology, some countries may require the taxpayer to store the material in a searchable electronic format instead of paper format. For example, the Republic of Korea provides in Article 85-3 of the National Basic Tax Act (NBTA) that taxpayers shall faithfully prepare and keep books and relevant documents relating to all transactions until the expiry of the statute of limitation. However, according to the NBTA, taxpayers are also allowed to prepare the above-mentioned books and the relevant documents through an electronic system, and, in this case, they are required to keep that information on a magnetic tape, disk or any other electronic storage. See OECD Transfer Pricing Guidelines (2017), paras 5.35–5.36.

from the close of the MNE's fiscal year to which the CbC Report relates.

12.4.2.5 The OECD Transfer Pricing Guidelines note that it would be quite burdensome if detailed documentation were required on all cross-border transactions between associated enterprises and by all enterprises engaging in such transactions. Therefore, it would be unreasonable to require the taxpayer to submit documents with the tax return specifically demonstrating the appropriateness of all transfer price determinations. The local file should, in particular, be limited to material transactions. As noted above, under the OECD/G20 guidance, the definition of materiality is left to local law and should be specified in the light of local conditions.

12.4.3 Penalties

12.4.3.1 A country that requires its taxpayers to prepare transfer pricing documentation may operate a penalty system to ensure proper compliance with its documentation requirements. Penalties in relation to the transfer pricing regime can be generally divided into two groups based on the reason for imposing them: (i) penalties for underpayment of tax that is due; and (ii) penalties for non-compliance with documentation requirements.

12.4.3.2 However, a number of countries also have incentive measures eliminating penalties for underpayment of taxes in cases where obligations for proper documentation have been fulfilled by taxpayers even in cases where the amount of taxable income turns out to be increased as a result of a tax audit. The principle governing these incentive measures is often referred to as the "no-fault, no-penalty principle".

12.4.3.3 In general, penalties can entail civil (or administrative) or criminal sanctions. Penalties imposed for failure to meet transfer pricing documentation requirements are usually monetary sanctions of a civil or administrative, rather than a criminal, nature. In some countries, a failure of the taxpayer to comply with documentation rules may lead to greater scrutiny by the tax administration and risk assessment and adjustments based on other information available to the tax administration or on the basis of other transfer pricing methods. These cases are more closely scrutinized, and can equally be seen as giving rise to greater risks of non-compliance.

12.4.3.4 It would be unfair to impose sizeable penalties on taxpayers that exert reasonable efforts in good faith to undertake a sound transfer pricing analysis to ascertain arm's length pricing, even if they do not fully satisfy documentation requirements. In particular, it would be unproductive to impose penalties on taxpayers for failing to submit data to which the MNE did not have access at the time of the documentation process, or for failure to apply a transfer pricing method that would have required the use of data unavailable to the MNE. However, this does not mean that a transfer price cannot be adjusted retroactively, with interest accruing on that amount.

12.4.3.5 Some countries consider that a penalty imposed due to a lack of proper documentation can be addressed through the Mutual Agreement Procedure between competent authorities under an applicable tax treaty, as it relates to the taxes to which the relevant treaty applies. Other countries consider that the issue of penalties, especially in relation to documentation, is distinct from the adjustments made and also from the issue of whether taxes have been imposed in accordance with the relevant tax treaty.

12.4.3.6 However, even where such a penalty is not covered by a tax treaty's Mutual Agreement Procedure, the penalty should not be applied in a manner that would severely discourage or invalidate a taxpayers' reasonable reliance on the benefits of the tax treaty. This includes the right to initiate the Mutual Agreement Procedure as provided in the relevant tax treaty.

12.4.3.7 For example, a country's requirements concerning the payment of an outstanding penalty should not be more onerous to taxpayers in the context of the Mutual Agreement Procedure than they would be in the context of a domestic law review initiated by the taxpayer.

12.4.4 Special Considerations for Small and Medium-sized Enterprises

12.4.4.1 Comprehensive documentation requirements and related penalties imposed on non-compliant taxpayers in a country may place a significant burden on taxpayers, especially on small and medium-sized enterprises (SMEs) or enterprises which engage in only limited cross-border transactions with overseas related parties. A number of countries have, therefore, introduced certain special considerations for SMEs in their transfer pricing documentation rules (see 11.4.3.3). Countries that have adopted special considerations for transfer pricing documentation in the case of SMEs include Brazil, China, Germany, India, Korea, Mexico, Nigeria, The Netherlands, Poland and Portugal.

12.4.4.2 The OECD/G20 BEPS guidance on documentation exempts MNEs with global revenues of less than EUR 750 million from the obligation to file the CbC Report, but rules as to whether SMEs should prepare the local file and master file are left to local law.

12.4.4.3 The accommodations made vary from country to country but may include: an exemption from documentation obligations for smaller companies or for companies that engage in only limited cross-border business, a delay in the time within which the documentation must be prepared and submitted until transfer pricing issues are raised on audit, or a reduction in the level of detail required to be submitted by smaller businesses. These accommodations can be incorporated in legislation or adopted through administrative practice.

12.4.5 Language to be Used for Transfer Pricing Documentation

12.4.5.1 The Final Report on Action 13 notes that a requirement to provide transfer pricing documentation in the local language can constitute a complicating factor for transfer pricing compliance since both time and cost may be involved in translating documents. The language in which transfer pricing documentation should be submitted should be established under domestic law. Countries are encouraged in the Final Report on Action 13 to permit filing of transfer pricing documentation in commonly used languages where it will not compromise the usefulness of the documents. Where tax administrations believe that translation of documents is necessary, they should make specific requests for translation. Where translation is required, the tax administration should allow sufficient time to make such translations to limit the compliance burden.

12.4.5.2 Many countries require taxpayers to present transfer pricing documentation in the (country's) local language and require translation if the documentation was prepared in a different language. The Egyptian transfer pricing guidelines provide that if documents are provided in any language other than in Arabic, the taxpayer may be required to bear the cost of an official translation. However, some countries such as France, Germany, the Netherlands and the Republic of Korea allow presentation of documentation in a language other than their own languages at least on an exceptional basis. It is particularly common to allow documentation to be provided in English.

13 Risk Assessment

13.1 Introduction

13.1.1 This Chapter and the two that follow it discuss aspects of the enforcement of transfer pricing rules by the tax administration. This Chapter (13) principally discusses the transfer pricing risk assessment usually performed by the tax administration at the beginning of an audit. Chapter 14 discusses aspects of the transfer pricing audit itself. Chapter 15 discusses the resolution of transfer pricing disputes.

13.1.2 An effective enforcement process seeks to achieve two important outcomes:

- To enhance and incentivize future compliance (which indirectly contributes to future tax revenue and protection of the tax base); and
- To increase current tax revenues through appropriate adjustments to the income reported by taxpayers when such adjustments are called for.

These objectives will be achieved only if the audit and dispute resolution process is managed successfully.

13.1.3 Transfer pricing audits are generally time and resource intensive. The hard work involved in a transfer pricing audit may result in the collection of significant tax revenue that can benefit a developing country. However, such results do not come quickly and easily.

13.1.4 The success of an audit often depends on the preparation and planning that take place in the first stages of the audit, especially in the risk assessment phase. Tax administrations do not have the resources to audit every cross-border transaction or every taxpayer. Accurate risk assessment enables informed case selection, which in turn helps the tax administration avoid wasting its enforcement resources. It is therefore important to dedicate adequate time and resources to risk assessment.

13.1.5 Risk assessment should be the first step of an audit and should continue through the various stages of the audit. Risk assessment involves an ongoing cost/benefit analysis, which helps to ensure the most efficient and effective use of tax administration time and resources and ensure that taxpayers are not unnecessarily inconvenienced when their compliance with the transfer pricing rules is evident. Risk assessment must be built into the auditing process and incorporated into an audit programme.

13.1.6 The OECD has published a handbook on transfer pricing risk assessment.[126] This provides guidance on how the information contained in the taxpayer's transfer pricing documentation can be effectively utilized to assess transfer pricing risks. This chapter does not seek to replicate all of the information in the OECD risk assessment handbook and tax administrations are therefore strongly encouraged to download the OECD handbook and to use it in developing their own risk assessment programmes.

13.2 Selection of Taxpayers for Transfer Pricing Examination: Risk Assessment

13.2.1 General Principles in Risk Assessment

13.2.1.1 Effective risk identification and assessment are important steps toward ensuring that the most appropriate cases are selected for audit. Given the resource constraints of tax administrations it is important for any tax administration that high risk transfer pricing cases do not "slip through the tax net". However, even the most robust risk identification and assessment tools and processes may not always guarantee success in audit. The reason for this is that the level of detail contained in information available to the tax administration at the risk assessment stage may not always be sufficient to draw reliable conclusions regarding the arm's length nature of profits/prices. A determination of whether the prices utilized by the taxpayer are in fact arm's length will depend on a functional analysis (based on the functions performed, assets used or contributed and risks assumed by each party), the transfer pricing methods applied, and so forth. The risk assessment does not involve a full functional analysis. It is instead intended to identify whether such a full analysis is warranted given the constraints on tax administration resources.

13.2.1.2 There are several ways in which a tax administration may conduct its risk identification and assessment, and the approach taken is largely dependent

[126] OECD (2017). *Country-by-Country Reporting: Handbook on Effective Tax Risk Assessment*. Paris: OECD Publishing. Available from http://www.oecd.org/tax/beps/country-by-country-reporting-handbook-on-effective-tax-risk-assessment.pdf

upon the type of information and data that is available and accessible. For example, exchange control authorities in some countries may work hand-in-hand with the tax administration enabling sharing of information between them; on the other hand, there may countries where such interaction may be prohibited. Some countries have strong filing and documentation requirements designed to ensure that relevant and appropriate information is submitted. The new global documentation standard described in Chapter 12 will provide most tax administrations with information that is useful in assessing transfer pricing risk.

13.2.1.3 It is important to draw a distinction here between the information related to filing a tax return and that contained in transfer pricing documentation. This may vary from country to country but in essence is as follows:

- Filing information typically relates to questions on a tax return. This may entail a tick-the-box (i.e. yes or no) or a "fill in the box" response (e.g. inserting a quantum or value);
- Documentation, in the context of transfer pricing, will generally include more substantial information such as answers to questions about the company's transfer pricing policy, identification of transactions with associated enterprises, legal contracts, valuations, identification of transfer pricing methods used, financial information, etc. For relevant taxpayers, transfer pricing documentation should now also include access to the CbC report reflecting income, taxes paid, and certain measures of economic activity on a country-by-country basis.

13.2.1.4 The OECD BEPS Action 13[127] provides detailed guidance on how the information provided under the documentation standard, and especially in the CbC report, can be used by tax administrations in conducting risk assessments.

13.2.1.5 A risk identification and assessment process, followed by engagement with the taxpayer, can be a worthwhile approach for tax administrations to adopt. This allows for better understanding of the risks identified and gives taxpayers the opportunity to explain the commercial context of the transactions/risks identified. Such an approach is designed to ensure that the risks have been profiled in the most robust manner before resources are committed to carrying out an in-depth audit.

[127] Ibid.

13.2.2 Categories and Identification of Risk

Overview

13.2.2.1 Intragroup transactions, e.g. payments for goods, services and intangibles, provision of financial assistance, etc. give rise to transfer pricing risk. Such transactions or categories of transactions are often readily identifiable on the income statement and/or tax return or from required transfer pricing documentation.

13.2.2.2 It may be useful to try to place the transfer pricing risks into categories to give added value and context to the risk identification and assessment process. Such categorization can assist risk profilers/assessors to evaluate the aggressiveness of taxpayer positions and the complexity of the risk, the possible amount of tax at stake, and the probability of generating significant tax revenue through audit. Such classification can help determine whether a case is worth pursuing and whether the requisite resources and expertise are available.

13.2.2.3 Some of the types of transfer pricing risk that may be considered in a risk assessment include:

- Category 1: Profit shifting through new transactions or structures;
- Category 2: Profit shifting through restructuring of business operations;
- Category 3: Other types of intentional profit shifting such as through incorrect functional classification, the use of incorrect methods, allocation keys etc.;
- Category 4: Issues involving "thick" or "thin" capitalization; and
- Category 5: Unintentional profit shifting.

13.2.2.4 The examples of risk categorization provided in the previous paragraph can assist the risk profiler/assessor in the evaluation of each of the following factors:

- The likelihood of detection by revenue authorities;
- The possible value or amount of the profit shifting (and therefore the potential value of the risk); and
- The amount of time and resources required to audit the risk (including the level of expertise required when drawing upon those resources).

Category 1: Profit Shifting Through New Transactions or Structures

13.2.2.5 This category includes new transactions and business structures implemented by MNEs with the intention of minimizing taxes by shifting profits. It is assumed that the potential tax reductions for groups implementing these types of transactions or structures may be significant and the tax risk is therefore assumed to be high.

13.2.2.6 Under the recommended transfer pricing documentation standard, important changes in corporate structure must now be disclosed (see Chapter 12). A tax administration's awareness of possible tax planning schemes and structures and its own analysis of potential loopholes in the tax system may help identify useful lines of audit inquiry.

Category 2: Profit Shifting Through Restructuring of Business Operations

13.2.2.7 This category is different from Category 1 as a tax minimizing/profit shifting structure is implemented at a certain point in time, resulting in a change to an existing structure or business model. Accordingly, this is referred to as a "restructuring". The risks associated with a restructuring are different for the various jurisdictions affected. The country where the MNE is headquartered (and possibly where the intangibles were originally developed and/or owned) would face different risks from those faced by a country where the MNE has a subsidiary undertaking manufacturing, distribution or marketing.

13.2.2.8 In this situation, the jurisdiction where the MNE is headquartered would face issues, such as the valuation of externalized intangibles, deemed disposals of assets for capital gains tax purposes etc. In addition, the headquarter jurisdiction may have to deal with the classification and benchmarking of profits for the "principal/entrepreneurial" entity remaining or created due to the restructuring.

13.2.2.9 On the other hand, the subsidiary jurisdiction(s) in Category 2 would mainly be concerned about risk stripping and loss of profits. The primary concern in this regard is that an entity has been stripped of its risks and responsibilities on paper (i.e. contractually), but it continues in practice to carry out the same functions or assume the same risks. The entity is effectively being paid less for doing the same things it was doing prior to the restructuring.

Category 3: Other Types of Intentional Profit Shifting

13.2.2.10 MNEs may intentionally shift profits through the misclassification of entities, the application of incorrect pricing policies or unsuitable allocation keys. For example, an entity may, during a period of economic upturn, be classified as a limited risk distributor and be rewarded with a fixed (but relatively low) profit margin, when it is in reality fulfilling the role of a fully-fledged marketer/distributor and should be sharing in the economic profits earned by the MNE as a whole. In another case, an MNE could be inappropriately allocating service charges as opposed to valuing the actual services performed, thereby extracting profits through excessive service charges.

13.2.2.11 It may be a challenge for a revenue authority to detect the types of intentional profit shifting activity by an MNE dealt with in Category 3. It may for instance require an evaluation of profit margins over an extended period against market/industry trends, an in-depth functional analysis of the entities that are party to the transactions and a detailed understanding of the pricing policies. The CbC report and other TP documentation may be useful in supporting this type of analysis.

Category 4: Financial Transactions and Other Issues Involving Thin or Thick Capitalization

13.2.2.12 This category of risk includes both intentional and unintentional profit shifting by MNEs using intercompany debt and capital to shift income into lower tax jurisdictions. In many countries, thin capitalization is regulated through limitations on allowable levels of debt to equity. Where this is the case, the likelihood for risk profilers/assessors of spotting such abuse is high, as these calculations can be easily performed or even automated to flag thinly capitalized entities. Where countries do not have prescribed limits, parameters or thresholds can be set for risk assessment purposes. Risks related to over-capitalization ('thick capitalization") may be harder to identify and challenge, as "bright line" tests related to excessive capital most often do not exist. It should also be noted that the treatment of thin capitalization here is at a general level and does not purport to address non arm's length interest deductions more generally. See also the guidance on financial transactions in Part B, at 9.5.

13.2.2.13 Local laws and regulations will influence the level and amount of resources required to audit these cases. Values can range from very low to very high, but their quantification should be relatively simple (in cases where safe harbours or risk assessment thresholds exist). This should be an area of focus for developing countries with simple thin capitalization rules as it could be considered what is often termed "low hanging fruit"—meaning that audit action in such a case may be quickly and easily rewarded by identifying amounts of tax that should be paid.[128]

[128] In connection with issues related to capitalization of members of the MNE and loans and other financial transactions between group members, see Chapter 9 containing detailed guidance on the application of the transfer pricing rules to financial transactions.

Category 5: Unintentional Profit Shifting

13.2.2.14 This category results from cases where mispricing by taxpayers occurs but was unintended. A revenue authority may disagree with the pricing policies applied, whether it be the functional classification, methods applied or other factors.

13.2.2.15 Where this occurs, it is possible that the values could be material. The level and quantum of resources required to audit the case would depend on the nature and extent of the perceived transgression by the taxpayer.

Possible "Flags" Suggesting Further Investigation

13.2.2.16 The following table summarizes some of the types of transfer pricing risk that can be identified in a transfer pricing risk assessment. These factors may suggest the need for additional audit investigation.

Table 13.T.1

Transfer Pricing Risks in Inbound vs Outbound Transactions

Type	Inbound Transactions/MNEs	Outbound Transactions/MNEs
Funding	Thin capitalization	Interest free loans
Interest rates	Excessively high interest rates	Excessively low interest rates
Goods	• Offshore procurement/sourcing companies to keep profits offshore • General mispricing (intentional/ unintentional)	• Offshore marketing companies to keep profits offshore • General mispricing (intentional/ unintentional)
Services	• Excessively high fees relative to benefit provided • Charging when no service received • Duplication/shareholder services	• No charge at all • Excessively low fees relative to benefit provided
Intangibles/ Intellectual property	• Excessively high charges • Duplicating charges through royalties over and above inflated prices	• Not charging for intangibles developed locally • Externalizing intellectual property without reward
Structures	• Restructuring • New structures	• Restructuring • New structure • To avoid/minimize imputation through controlled foreign corporations • Use of offshore branches in low-tax jurisdictions with double taxation treaties

13.2.3 Possible Approaches in Risk Assessments

Overview

13.2.3.1 There are various approaches that one could take in order to identify companies/groups with transfer pricing risks. These include:

- The transactional approach;
- The jurisdictional approach; and
- The risk-based approach.

13.2.3.2 Where specific transfer pricing risks are identified, the tax administration can design an audit programme that will efficiently investigate whether adjustments to income are appropriate under applicable transfer pricing statutes and regulations.

Transactional Approach

13.2.3.3 In order to start building capacity and expertise through on-the-job training it may be useful to adopt a transactional approach under which simpler transactions, which may be easier to price, are audited first. Some transactions are more easily identifiable but not necessarily easily audited in all circumstances. Restrictions on access to information in a particular jurisdiction may limit the kinds of transactions that may be easily audited.

13.2.3.4 Alternatively, the focus could be on higher risk transactions with a higher possible revenue yield, such as business restructurings, for example. Finally, examination of a combination of more complex and simpler transactions can be adopted in order to ensure a more consistent flow of work and revenue.

Jurisdictional Approach

13.2.3.5 A revenue authority may adopt an approach under which transactions entered into with entities located in specified tax jurisdictions are prioritized for audit. A crucial element of this approach is the inclusion of both direct and indirect transactions entered into with such jurisdictions, e.g. schemes or structures ultimately benefitting or involving entities in these identified jurisdictions. This will require the transfer pricing unit to identify those jurisdictions it considers to be of higher risk, within the context of domestic tax rates, trade flows, tax treaties and economic policies.

13.2.3.6 It may be that transactions involving related parties in jurisdictions with higher tax rates are flagged for prioritization where those jurisdictions are perceived to have particularly aggressive transfer pricing rules or enforcement practices. MNEs may apply transfer pricing in such a way that it favours the more aggressive jurisdiction (in order to avoid potential audits in these jurisdictions) at the cost of the jurisdiction where transfer pricing is not as aggressively pursued. In adopting this approach, care should be taken not to act contrary to international non-discrimination rules such as may be found in applicable tax treaties and/or domestic law.

Risk-based Approach

13.2.3.7 This is in essence a hybrid of the transactional and jurisdictional approaches, but could also consider factors other than the jurisdiction of the related party or parties and the type of transactions.

13.2.3.8 Other factors of interest might, for instance, include:

- The tax compliance status of the local entity or the MNE to which the entity belongs, i.e. how compliant the company/group generally is with transfer pricing and other tax/ regulatory requirements in that country or elsewhere in the world. Where groups/entities have been successfully investigated by other revenue authorities this could provide an indication that the group presents a higher risk for transfer pricing purposes;
- A group that has recently undergone a business restructuring, particularly where the local entity has been "stripped" of certain risks and/or functions as part of the restructuring; and
- Companies with excessive and/or continued accounting or tax losses despite there being profits at the consolidated group level.

13.2.4 Sources of Information for Risk Assessment

13.2.4.1 Tax authorities should work as far as possible with the information provided by the taxpayer. The tax return should ultimately aim to obligate taxpayers to include the information that would be most useful for the tax authority to utilize for effective risk assessment. Information provided as part of the taxpayer's transfer pricing documentation will be an important source of information for a risk assessment. The use of quantitative rather than qualitative data will assist in the automation of risk assessment tools. Examples of useful information on transactions include the value of the following transactions with any cross-border related party:

- Sales;
- Purchases;
- Loans, including interest received and/or accrued;
- Royalty payments;
- Service fees;
- Derivatives transactions;
- Debt factoring or securitization transactions; and
- Share remuneration transactions.

Most of this data will be included in the transfer pricing documentation described in Chapter 12.

13.2.4.2 Publicly available data can be useful. This includes newspapers, websites, databases and publications such as “Who owns Whom” or databases of company financial information. Unfortunately, access to databases and publications in this area can be expensive, and developing countries may often have to be more reliant than their colleagues in developed countries on information provided by taxpayers.

13.2.4.3 Published judgments of cases heard in other countries may contain useful intelligence regarding a group’s activities, transactions and pricing policies. These could also provide useful guidance on structures/schemes implemented in certain industries. The analyses of such decisions provided by law and accountancy firms to their clients are often freely available, and can also be helpful in identifying similar issues in another jurisdiction. Access to transfer pricing information databases summarizing and often including the full judgements, such as those issued by commercial publishers, can also be useful, if the cost of at least one licence can be borne by the administration’s budget or through donor support. Comprehensive transfer pricing databases used in transfer pricing analyses also often have a searchable database of new developments.

13.2.4.4 Particular attention should be paid to any notes to the financial statements on related party transactions and loans/financial assistance.

13.2.4.5 Customs data can, in some cases, be relevant to obtaining information on intragroup transactions. Sometimes the declared import price may be an indicator of the true transfer price. See Chapter 3 for more details on the use of customs data for transfer pricing purposes; especially section 3.6.6.

13.2.4.6 As noted above, information from the taxpayer’s transfer pricing documentation can be very useful.

13.2.5 Risk Factors

13.2.5.1 Certain risk factors or "flags" can point to the need for further examination. However, such factors should not be treated as decisive in determining that non-arm's length pricing has occurred. Instead, these factors point to a higher than normal likelihood of mispricing and suggest that further review is warranted. Identified risk factors may include:

- Consistent or continued losses;
- Significant transactions with related parties in countries with lower effective/marginal tax rates, especially "secrecy jurisdictions" from which tax information is not likely to be shared;
- Local low profit or loss-making companies having material cross-border transactions with related parties offshore, where the offshore part of the group is relatively much more profitable;
- The existence of centralized supply chain companies in favourable tax jurisdictions, i.e. centralized sourcing or marketing companies located in jurisdictions with low-tax or no-tax regimes and which are not located in the same country/region as the group's main customers and/or suppliers;
- A poor tax compliance history;
- Lack of documentation to support transfer prices;
- Significant inconsistencies between profits of an individual group entity and the profits of the group;
- Any significant reduction in local entity profits after such an entity is acquired by an MNE;
- Material commercial relationships with related parties in jurisdictions with aggressive/strict transfer pricing enforcement (see 13.2.3.5. above). This also applies in the case of material commercial relationships with companies located in the "home" jurisdiction of the MNE or the location where the holding company is listed; or
- Material commercial relationships with companies in jurisdictions that employ safe harbours or similar rules that do not always align with the arm's length principle.

13.2.6 The Risk Assessment Process

13.2.6.1 As stated, the risk identification and assessment process may vary from one tax administration to another depending on the approach taken, the resource capability, and the stage at which potential challenges are considered. Some tax administrations have very sophisticated processes employing computerized systems and computational analyses, while others may adopt a more simplified process. Ultimately the risk identification and assessment process will depend on what a tax administration has at its disposal in terms of information, capability and systems or technology. It can, however, be said that the more refined and sophisticated the risk identification and assessment process, the easier it will be to ensure that high risk transactions are identified and audited in a timely manner.

13.2.6.2 The basic steps of the risk assessment process can be described as follows:

- Initial review and identification of the possible risks;
- High-level quantification of the possible risks;
- Gathering of other intelligence;
- Decision as to whether to proceed;
- More in-depth risk review including high-level review of documentation and functional analysis to confirm initial findings;
- More detailed quantification of possible risks;
- Initial interactions with the taxpayer; and
- Decision as to whether to proceed to audit by way of specialist reviews or committee based/panel reviews.

The OECD risk assessment handbook referred to at 13.1.6 contains detailed suggestions on how the risk assessment process may be carried out.

13.2.7 Risk Assessment Tools

13.2.7.1 Some of the more common risk identification and assessment tools include calculation templates for calculating key ratios relevant to transfer pricing. Such tools are relatively basic, based on quantitative information readily available to non-transfer pricing tax inspectors and on transfer pricing documentation. This may include, for example, information available from the tax returns and audited financial statements to assist tax inspectors in identifying (or "flagging") those cases with probable transfer pricing/thin capitalization risks.

13.2.7.2 Where specialist transfer pricing capability and resources are limited, generalist tax inspectors/auditors may be used to assist with risk identification and assessment. In such cases these basic tools ideally do not require generalist auditors to apply their discretion or have specific transfer pricing knowledge. They merely require the auditors to input certain data, run the calculations (if not automated) and report the results (where above or below certain pre-established thresholds) to the transfer pricing unit. The decision as to whether to involve the auditor going forward is then a decision that should be made on a case-by-case basis by those with special transfer pricing expertise as part of the audit process.

13.2.7.3 Basic quantitative risk assessment tools are particularly effective in the identification of thin capitalization risks as this usually involves a quantitative test of the financial data and is in most cases, depending on the local legislation, a matter of objective fact rather than more subjective opinion. Automated risk assessment tools that can be used to run through large sets of available data can be used very effectively in this area.

13.2.8 Risk Assessment Findings

13.2.8.1 It is important that the outcomes of a risk identification and assessment process be documented and signed off for governance and control purposes and preferably saved in a central repository, i.e. a database of cases assessed, whether or not leading to a detailed audit or to tax assessment.

13.2.8.2 The tax administration should design templates containing key information relevant to their domestic requirements. Ideally these should include:

- Statutory filing requirements (e.g. tax number etc.);
- The nature of the transactions and risks identified;
- The quantification of risk, where possible;
- The jurisdictions with which the transactions occurred;
- The information reviewed e.g. the financial statements, tax return, etc.;
- The outcome of the risk identification and assessment process, i.e. what was recommended and why; and
- Specific issues and transactions identified for further audit.

14 Transfer Pricing Audits

14.1 Planning a Transfer Pricing Examination

14.1.1 Overview

14.1.1.1 The tax administration should organize an audit team and proceed with an audit where the risk assessment (discussed in Chapter 13) concludes that a full transfer pricing audit of one or more issues is appropriate. This section details the considerations to be taken into account in conducting a transfer pricing audit.

14.1.2 Formation of the Examination Team

14.1.2.1 Where the appropriate unit of the tax administration (see section 11.5) decides to examine transfer pricing, the examination team should ideally be comprised of:

- A manager who typically has responsibility for more than one audit;
- A team leader who will manage the day-to-day examination of a taxpayer;
- A domestic examiner who is responsible for audit activities primarily relating to domestic issues;
- An international examiner who is responsible for audit activities primarily relating to international issues including transfer pricing;
- A transfer pricing economist who provides economic analysis and support for the audit;
- A lawyer who is available for consultation on legal aspects and may be involved in audit planning and implementation;
- A computer audit specialist who assists with the software needed to analyze computer readable data received from the taxpayer, and in organizing the data to assist the domestic and

international examiners as well as the economists in analyzing transfer pricing issues; and

- Where possible, the team should also include an industry specialist.

14.1.2.2 The above-mentioned persons may not always be present in one examination team and may be consulted as needed. The availability of resources may depend on the stage of the audit process, the organizational structure adopted by the tax administration in question and the staffing/capacity constraints of the tax administration; see further sections 11.5 and 11.6. One person may be able to effectively perform two or more of the above functions. The skill groups identified above illustrate the knowledge and expertise needed for a transfer pricing audit team.

14.1.2.3 The international examiner, the transfer pricing economist and the lawyer are likely to be present in most cases. The international examiners are indispensable in the light of the international nature of transfer pricing. They receive special training in international issues and, in many cases, are more senior and experienced than domestic examiners. The team leader often consults the international examiner.

14.1.2.4 A transfer pricing economist should be involved from the inception of the audit. An economist is almost always involved in:

- The functional analysis of the taxpayer's business;
- Assisting in the selection of comparables;
- Assisting in the selection of the methodology to be applied;
- Providing an analysis of whether the prices for the transactions in question meet the arm's length standard;
- Assisting the audit team with respect to the economic arguments when in discussion with the taxpayer; and
- Preparing or assisting the preparation of a report addressing the conclusions of the team.

14.1.2.5 The lawyer will often be involved at an early stage in reviewing important substantive or procedural decisions. Additionally, the lawyer will be consulted concerning the procedures to be used for information gathering, may be involved in drafting questions posed in information requests and may also participate in interviews of company personnel. The lawyer is expected to contribute to more carefully crafted inquiries for information and to resolve administrative and substantive issues. Also, the participation of the lawyer in the audit process may expedite and make the preparation of the case for possible litigation more effective.

14.1.3 Supervision of Examination

14.1.3.1 A key issue for a tax administration is to ensure transfer pricing audit approaches are uniform over the whole country. This is especially a pressing problem for a country which has a vast geographical area to cover. An illustration of an effort to solve the "uniformity" problem can be seen from the case of Japan.

14.1.3.2 When Japan enacted its transfer pricing legislation in 1986 it faced the issue of ensuring uniformity in administration of the rules. There were twelve regional taxation bureaux, while a single unit had to supervise the transfer pricing assessments done by these bureaux. From the outset, a rule was established that prior approval from the Director (International Examination) in the Large Enterprise Examination Division of the National Tax Agency had to be obtained before a transfer pricing division could issue a correction notice to adjust transfer pricing of a taxpayer. Such an approval request had to be supported by an explanation of the facts of the case and the reasons for the adjustment. Transfer pricing divisions were also encouraged to consult the Director (International Examination) during the course of the examination.

14.1.3.3 This was possible at the early stages of transfer pricing enforcement because the number of transfer pricing cases was small. As the number of transfer pricing cases increased, however, it became impossible for the Director (International Examination) to supervise all cases. Therefore, gradually, the supervisory power has been delegated to the Senior Examiner (International Taxation) at each regional taxation bureau. The Director (International Examination) now supervises only the larger transfer pricing audit cases. It is now possible to supervise transfer pricing audits at the level of the regional taxation bureaux as the number of tax officials who share common knowledge and expertise in transfer pricing has increased considerably.

14.1.4 Issues for Examination/Examination Plan

14.1.4.1 It is necessary to decide what issues will be investigated in a transfer pricing examination.[133] This will be based on the risk assessment and involves the establishment of a transfer pricing examination plan.

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[133] Transfer pricing audits can also be described as "examination" programmes, though it is also possible to use the term "examination" in a wider sense, e.g. to cover compliance checks of transfer pricing processes without doing a full-scale audit.

14.1.5 Audit Timetable

14.1.5.1 A transfer pricing audit usually takes longer than an ordinary tax audit because the scope of the factual matters to be investigated is much broader. The amount of time and effort needed for transfer pricing analysis is also typically much greater. In general, the time needed would be an average of one to two years.

14.1.5.2 Experience has shown that examinations rarely proceed in accordance with the timetables set forth in the examination plan. The main reason is that progress depends on whether the information requirements set forth in the examination plan are satisfied. Unfortunately, required information is not always obtained on time. It may be necessary to check the progress of the audit periodically to reconsider the audit timetable and the extent of information needed by the audit team.

14.1.6 Statute of Limitations as Provided for in the Domestic Law

14.1.6.1 The statute of limitations period for transfer pricing cases may be the same as, or different from, that for ordinary tax cases. The United States applies the same three-year statute of limitations period to both ordinary tax disputes and transfer pricing disputes. The United Kingdom (six years), Germany (four years) and France (four years) also have the same statute of limitations period for both. On the other hand, Japan applies a statute of limitations period of six years to transfer pricing cases while the statute of limitations period on ordinary corporate income tax liabilities is five years. Canada's statute of limitations period is six years for transfer pricing cases and three years for ordinary tax cases.

14.1.6.2 Another aspect of the statute of limitations period is its permanence i.e. whether it is fixed or whether the taxpayer can waive the benefit accorded. For example, in the United States a taxpayer can waive the benefit of the statute of limitations but in other countries, including Japan, the statute of limitations period is fixed.

14.1.7 Approvals and Sign-off

14.1.7.1 Once a transfer pricing audit has started, it will require considerable investment of time and effort by the examiners. It is best to require the approval and sign-off by a senior officer or the tax administration's committee on transfer pricing audits before the examination starts. This is important from the viewpoint of effective use of the tax administration's human and other resources.

14.2 Preliminary Examination

14.2.1 Desk Audit

14.2.1.1 Normally, the tax authority will have certain transfer pricing information in its possession before a transfer pricing audit starts (see 14.3.3.2). A desk audit of such information, especially financial statements, should be made to evaluate whether there are any transfer pricing issues. For instance, computing the following financial ratios based on tax and financial data may be useful:

- Gross profit to net sales;
- Operating profit to net sales;
- Operating expenses to net sales;
- Gross profit to operating expenses (Berry Ratio); and
- Operating profit to average total assets.

14.2.1.2 Comparing the taxpayer's financial ratios to applicable standard industry ratios is useful if standard industry ratios can be found. Substantial deviations from standard industry ratios may indicate a transfer pricing problem. The findings from the desk audit should be analyzed to determine what further action, if any, is needed.

14.2.2 Understanding the Taxpayer's Business

14.2.2.1 Understanding the taxpayer's business operations is an essential part of the transfer pricing examination. This can commence before starting a transfer pricing audit, and should include an understanding of:

- The taxpayer's operations;
- The operations of the taxpayer's affiliates (domestic and foreign);
- The relationships between the taxpayer and its affiliates (domestic and foreign);
- Key value drivers in the business;
- The role each entity plays in carrying out the activities and performing the business functions of the controlled group;
- The scope, volume and nature of controlled functions; and
- How much control and direction the taxpayer receives from the headquarters of the group.

14.2.2.2 The following may be useful sources for gaining an understanding of the taxpayer's business operations:

- Transfer pricing documentation;
- Annual reports;
- Securities reports;
- Publications describing the taxpayer's operations;
- Reports published by securities companies;
- Internal audit and management reports;
- Organization charts and business flow charts (accessing these may require the taxpayer's cooperation);
- Minutes of board meetings, committee meetings and shareholders' meetings;
- Material contracts between the MNE's local affiliates and other entities within the MNE;
- Policy and procedure manuals;
- Internal approval documents;
- Written intercompany pricing policies;
- Customs declaration documents;
- Sales catalogues, brochures, and pamphlets; and
- E-mails and other written correspondence between the taxpayer and its affiliates.

14.2.2.3 The following questions are among those which may be asked in order to understand the taxpayer's operations:

- If the taxpayer is engaged in the *distribution* of products:
  - Are affiliates manufacturing the same or similar products to those distributed by the taxpayer?
  - Is technology transferred between affiliates and the taxpayer?
  - Are trademarks and other marketing intangibles being used to market the product?
  - Which members of the MNE developed the trademarks and other marketing intangibles?
  - Which members of the MNE devise and carry out advertising activities?
  - Which members of the MNE created the sales tools?
  - Which members of the MNE created and maintained the list of customers?
- If the taxpayer is engaged in the *manufacturing* of products:

- Are affiliates distributing or selling the same or similar products to those the taxpayer manufactures?
- Is the taxpayer using the same or similar manufacturing intangibles to those its affiliates are using?
- What patents and/or know-how are involved in the manufacturing process?
- Is there a cost contribution arrangement?
- Did affiliates or the taxpayer buy into a cost contribution arrangement?
- What research and development is conducted?
- What members of the MNE direct and perform research and development?
- How are the results of research and development disseminated among members of the MNE?

14.2.2.4 As intangibles may be an important aspect of the taxpayer's business, gaining an understanding regarding a taxpayer's intangibles may also be useful:

- Manufacturing and marketing intangibles;
- Domestic and foreign patents;
- Licenses and assignments;
- Patent, trademark or other intellectual property litigation involving the taxpayer;
- Domestic and foreign trademark development and registration; and
- Copyright creation and registrations.

14.2.3 Understanding the Industry in which the Taxpayer Operates

14.2.3.1 The following items may be helpful in understanding the taxpayer's industry:

- Identifying any relevant industry association;
- Reviewing the industry association's publications and website;
- Reviewing industry guidelines used by the taxpayer;
- Consulting with various industry experts;
- Consulting various books and articles on the industry;

- Identifying competitors in the same industry;
- Comparing the competitors' activities with those of the taxpayer; and
- Comparing the competitors' financial data with those of the taxpayer.

14.2.4 Approval

14.2.4.1 The approval of a senior officer, in accordance with the organizational model of the transfer pricing administration, will usually be required before embarking on a full-scale transfer pricing audit of the taxpayer when the preliminary examination is completed.

14.3 Audit Procedure

14.3.1 Audit Approach

14.3.1.1 The examiners need to establish the transfer pricing audit plan, which may be divided into two parts:

- Part one identifies the audit team, the information they expect to obtain and the timetable for the examination. This part can be disclosed to the taxpayer under investigation; and
- Part two identifies the tax administration's resources to be devoted to the examination, the accounts and transfer pricing issues under examination, the anticipated procedures for the examination of each issue, the personnel responsible for the various steps and the management procedures to be followed by the audit team. The information in part two is generally not disclosed to the taxpayer.

14.3.2 Notification to Taxpayer

14.3.2.1 A transfer pricing audit usually brings the examiners into contact with the taxpayer by phone for scheduling an initial appointment. If such contact cannot be made the examiners will send a letter notifying that they will audit the taxpayer. This is the time when the examiners send the initial information request to the taxpayer. If contemporaneous documentation is to be submitted, the request will signal the start of the period of submission.

14.3.2.2 A transfer pricing audit is usually concerned with transfer pricing aspects only. However, an ordinary corporate income tax audit may develop into or include a transfer pricing audit if necessary. The number of taxable years to be covered by an audit is generally restricted by the statute of limitations. For example, if the statute of limitations is six years, the taxable years to be covered may be up to six prior years.

14.3.2.3 The examiners will usually suggest a meeting with the taxpayer, to discuss the audit schedule and certain ground rules. If the taxpayer has submitted certain requested documents the examiners may also discuss the contents of such documents.

14.3.3 Gathering of Information

14.3.3.1 The major activity in a transfer pricing audit is the gathering of information that the tax authorities consider necessary to decide whether to accept tax returns as filed or to propose transfer pricing adjustments. The tax authorities rely primarily on the taxpayer to provide that information.

14.3.3.2 Certain information needed for the transfer pricing audit may already be in the hands of the tax authorities:

- **Tax returns**: tax returns of the taxpayer are the most basic information documents;
- **Financial statements:** financial statements of the taxpayer under generally accepted accounting practice (GAAP) are often required to be submitted to the tax authorities together with the tax returns and constitute important financial documents for the transfer pricing audit;
- **Documents attached to the tax returns:** taxpayers may be required to attach schedules or other forms containing information on their transfer pricing practices to a tax return; and
- **Other information returns**: information returns may be required for transfer pricing purposes.

14.3.3.3 Other necessary information may be requested by the audit team. The audit team's authority for making the information request is based on the tax authorities' general investigation authority or information powers provided for in a country's taxation law. Certain countries have specific statutory provisions for requesting information regarding transfer pricing issues.

14.3.3.4 It should be noted that the taxpayer's cooperation in providing the required information is essential in a transfer pricing audit; in this respect it differs from many ordinary tax audits. In the case of an ordinary tax audit, the taxpayer usually has no obligation to create a document for tax examiners. Further, it is often necessary in a transfer pricing audit for the taxpayer to explain its business operations. Taxpayers are expected to cooperate with the audit team in providing the necessary data and explanations, and a cooperative atmosphere during transfer pricing audits is desirable and to be encouraged.

14.3.3.5 The principal means for the audit team to collect the necessary information is through written information request(s). The information request is usually backed up by civil or criminal penalties for failure to comply. Multiple information requests are likely to be issued by the audit team during a transfer pricing audit. The time given for responding is usually a few weeks, unless the taxpayer is expected to take a longer time to obtain and/or prepare the required information. Tax authorities can also utilize the exchange of information provision in an applicable tax treaty.

14.3.3.6 It should be noted that a common problem is the challenge in enforcing an information request which seeks a document or information not held by the taxpayer under investigation, but rather by a related but legally distinct party outside the country. In the case of Japan, for example, the Japanese taxpayer is required to make efforts to obtain the documents and accounting books held by its related party outside Japan. The Japanese tax authorities have the statutory authority to impose presumptive taxation if the requested data is not submitted by the taxpayer.

14.3.3.7 The United States has more forceful means of obtaining documents located outside the country. Firstly, the Internal Revenue Service (IRS) may issue a Formal Document Request (FDR) to a taxpayer to request foreign-based documentation under Section 982 of the Internal Revenue Code (IRC) after normal request procedures have failed. If the taxpayer fails to substantially comply with the FDR within 90 days, it may be precluded from introducing any foreign-based documentation covered by the FDR as evidence at a trial where the documentation is relevant. Secondly, the IRS can request a taxpayer to obtain authority from a foreign related entity to act as an agent of that entity for the purposes of a summons under Section 6038A(e) of the IRC. Where the taxpayer fails to obtain the authorization, the IRS may determine the amount at issue based solely on the information available to it. Thirdly, the Third-Party Summons procedure is available to the IRS under Section 7602 of the IRC. The IRS must provide “reasonable notice” to the taxpayer before contacting any other party regarding the taxpayer’s tax liability and must provide to the taxpayer a list of the persons contacted by the IRS periodically or upon the taxpayer’s request.

14.3.3.8 It may be useful to interview the personnel of the taxpayer engaged in marketing and sales and those in the accounting and financial departments. It is often useful to visit the taxpayer’s premises (e.g. shops, factories, etc.). to understand the taxpayer's business. During the audit, the audit team may want to arrange this visit with the taxpayer.

14.3.3.9 Necessary information can also be collected from other sources such as the taxpayer's website, the taxpayer's submission of periodic financial data to the securities regulatory agency (if relevant), business journals, other tax filings (related and unrelated to the taxpayer), etc. If the information is publicly available, the audit team can freely use the contents of such information but if it is confidential the audit team must exercise care in disclosing such information.

14.3.4 Sources of Information

14.3.4.1 As noted above, the principal information source is the taxpayer. The taxpayer's books, records and other written documents, and its directors and employees are the principal sources of information.

14.3.4.2 A former employee or director of the taxpayer may also be a source, if necessary. In this event the former employee or director may be bound by a contract with the taxpayer not to disclose any secret information. This often raises a difficult legal question as to whether the former employee is obliged to disclose the requested information to the tax authorities. This question must be resolved in light of the domestic law of the country concerned.

14.3.4.3 A third party is also a possible source of information. For example, Japanese tax law authorizes the Japanese tax authorities to request information from a corporation engaging in a business activity which is of the same type or examine the accounting books and documents of that person or corporation.[134] Tax returns of a third party in the same business will also be useful sources of information. When a third party's information is used, the tax authorities are confronted with a statutory obligation of confidentiality when dealing with the taxpayer. This is often discussed in the context of secret comparables.

14.3.5 Language

14.3.5.1 The documents a taxpayer possesses with respect to its transactions with a foreign related party are often written in a foreign language that tax auditors may not understand. Tax law in most countries is generally silent as to which side should translate the foreign language documents necessary for a transfer pricing audit. If the documents are voluminous the cost of translation may be substantial.

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[134] Japanese Special Taxation Measures Law Art. 66–4, see para. 8.

14.3.5.2 When the relevant documents are written in a foreign language, the examiners frequently request the taxpayer to translate the foreign language into the domestic language at its own cost, and the taxpayer is often cooperative as a matter of practice. However, the legal basis for the practice is not always clear. See 12.4.5.

14.3.5.3 If a document necessary for a transfer pricing audit is written in a foreign language and cannot be understood by the examiners, it will generally be the party with the burden of proof that will suffer a disadvantage.

14.3.5.4 The English language may have a unique position as a foreign language in this context. In most non-English speaking countries tax examiners in charge of transfer pricing taxation are trained to understand English and may be able to read documents in English.

14.3.6 Types of Information to be Gathered

14.3.6.1 General information required for a transfer pricing audit includes:

- A corporate profile;
- The organization of the taxpayer and the related parties;
- The transactions or business flows;
- A list of manufacturing and/or sales facilities;
- A list of directors and employees; and
- A diagram of group affiliates indicating capital relationships.

14.3.6.2 Much of this information can now be found in the taxpayer's transfer pricing documentation, assuming it has been prepared in compliance with the recommended standard described in Chapter 12.

14.3.6.3 The taxpayer's financial statements provide basic financial information. However, the transfer pricing audit is often focused on the sales or purchases of particular products, the provision of particular services or the licensing of particular intangibles. It then becomes necessary to segment revenues, expenses, gross profit and/or operating profit. A segmentation of the profit and loss statement is thus often conducted, focusing on transactions under review by the tax auditors. The preparation of segmented profit and loss statements will require additional work by the taxpayer, who knows the details of the profit and loss statements. The accurate review and assessment of the financial results will often be impossible without segmented profit and loss statements.

14.3.6.4 Third-party information required is basically comparable data. The sources of the third-party information may vary depending on the possibility of finding appropriate comparables. See further Chapter 3 on Comparability Analysis.

14.3.7 Points for Examination at the Initial Stage

14.3.7.1 In order to correctly ascertain whether any issue exists in relation to the transactions in the examination process, each case should be examined carefully, bearing in mind the circumstances of each transaction. In conducting a transfer pricing audit, the following points should be taken into consideration along with the functions performed, risks assumed, and assets used or contributed used by the taxpayer and by the persons compared:

- Whether the gross and operating profit margins arising from related transactions of the taxpayer are significantly different compared with those of other transactions conducted by the taxpayer with unrelated persons in a similar market and which are similar in quantity, market level and other respects;
- Whether the gross and operating profit margins arising from related transactions of the taxpayer are significantly different compared with those of other unrelated persons engaged in the same category of business that are similar in quantity, market level and other respects; and
- Whether the taxpayer's gross and operating profit margins arising from related transactions are significantly different compared with those of the related persons arising from the same transactions.

14.3.7.2 Prior to the calculation of arm's length prices, examinations should be conducted from different viewpoints in order to determine whether there are any issues regarding transfer pricing and to ensure that the examinations are conducted effectively. The following methods could be used:

- Verification of whether or not the gross and operating profit margins of related transactions under the examination are within the range of the profit margins of uncontrolled transactions in the same business category and substantially similar to the related transactions in terms of quantity, market level and other respects; or
- Use of the average value of the consideration or profit margins for related transactions or transactions deemed comparable with the related transactions during a reasonable length of time before and after a taxable year under examination. This may be done if it is considered inappropriate to examine the price of

inventory products and other aspects of the related transactions based only on the information for each relevant taxable year, due to considerable fluctuations in prices reflecting changes in public demand, product lifecycle or other such factors.

14.3.7.3 Once the transfer pricing audit starts, various aspects of arm's length pricing will be involved and will consume a considerable amount of time. After the above examinations, it may be useful to pause to reflect upon the audit in general. This will occur before starting the calculation of an arm's length value, which will consume the biggest part of the transfer pricing audit resources. The auditor should review whether it is likely that continuing the transfer pricing audit would produce a fruitful result from the viewpoint of efficiency.

14.3.7.4 Contemporaneous documentation is explained in detail in Chapter 12. The contemporaneous documentation the taxpayer has prepared will be important for the examiners and should be among the first items they request.

14.3.7.5 The taxpayer is usually required to provide the examiners with the contemporaneous documentation within a specified number of days after a request from the tax authorities. Such documentation should demonstrate that the transfer pricing method and its application provide the most reliable measure of an arm's length price. This represents the first opportunity for the taxpayer to persuade the examiners that the transfer pricing is appropriate.

14.3.8 Information Request / Supplemental Information

14.3.8.1 The following is a sample list of information documents required from a corporation engaged in the distribution of products on the assumption that the taxable period under audit is five years. The requested information should be the most up to date unless otherwise required.

- ➢ Corporate profile information (including the corporate group's history);
- ➢ Organizational chart (setting out the number of employees);
- ➢ Transactional structure: a business flow chart (invoicing and settlement, and actual delivery flow);
- ➢ List of distribution channels and retail outlets if applicable: location, size, opening hours, sales revenue, staffing, prices, contractual terms with customers (consignment/cash sales etc.) including data on the latest three years for sales, revenue and staffing;
- ➢ List of directors;

- Equity structure of group companies;
- Basic business agreements, distribution agreements and other agreements with related parties;
- Corporate profile of the related parties;
- Documents related to determination of arm's length price;
- Transfer pricing method and list of margins by categories of product for five years;
- Latest financial data regarding the sales, cost of goods sold, operating expenses, operating profits and profit before tax for the past five years;
- Group global consolidated profit and loss statement and ratio of taxpayer's sales to group global sales for the past five years;
- Segmented profit and loss statements from the related transactions of the related party (if the taxpayer is the purchaser) or the taxpayer (if the taxpayer is the seller) for the past five years;
- List of gross and operating profits by category, by product and by distribution channel with detail of losses on disposal of assets and losses from obsolescence for the past five years; and
- Top ten products in sales by category (name of product, purchase price and retail prices, personnel expenses, advertising expenses and sales promotion expenses) for the past five years.

14.3.8.2 As the transfer pricing examination progresses many more questions will arise in the minds of the examiners and, accordingly, supplemental information requests will likely need to be issued by the examination team. This part of the examination process tends to be lengthy.

14.3.9 Request for Interviews

14.3.9.1 It is common in a transfer pricing audit for the examination team to request interviews with key company personnel involved in transactions with related parties. The interviews assist the examination team's functional analysis for purposes of determining the functions performed by the taxpayer and related parties and evaluating potential comparable transactions. Transfer pricing economists and the international examiners on the examination team will almost always participate in the interviews, and a lawyer may also be involved. The aspects noted below are pertinent to the taxpayer's responses to the requests for interviews.

14.3.9.2 The examination team will choose the personnel to interview after reviewing organization charts. The personnel to be interviewed are decided by the examination team based on mutual discussion of the functions of the personnel in the organization charts.

14.3.9.3 The interviewees should be made familiar with the process and should understand the procedures, purpose and importance of the interview.

14.3.9.4 Interviews are usually conducted in a cooperative manner. The taxpayer may work with the examination team to agree on the rules of the interview in an advance agreement, to avoid confusion. For example, the taxpayer may wish to arrange for the examination team to meet with a group of employees, rather than meet each person separately. In this way the employees have an opportunity to consider the responses of other individuals. On the other hand, the examination team may want to interview each person separately.

14.3.9.5 If the person to be interviewed is not a native speaker of the language of the interview it is advisable to use an interpreter even if he/she can speak the language fairly well. The use of an interpreter will avoid the possibility of misunderstanding questions and allow the interviewee time to formulate reasoned responses.

14.3.9.6 If an interview is recorded, both parties should keep a copy of the record. It may be useful to have a transcription of the interview record rather than merely an audio recording, considering the possibility and ease of future use. If no recording of an interview is taken, the examination team may produce a summary of the interview and provide this to the interviewee. A careful review of the written summary is needed in such event.

14.3.10 Request to Visit Facilities

14.3.10.1 The extent of cooperation for the tax examiners' visit to a taxpayer's facilities will vary from case to case. Representatives of the examination team could be accompanied on the visit by an employee of the taxpayer who can describe the activities at particular locations and respond to questions. This guide should consider the exercise as being similar to an interview or an opportunity to present factual portions of the taxpayer's case as this explanation may affect the taxpayer's position in describing objects or operations on the tour. Ensuring integrity of such contacts with taxpayers is as important here as in other cases of dealing with taxpayers.

14.3.11 Secret Comparables

14.3.11.1 There is an issue concerning secret comparables which often surfaces in connection with transfer pricing audits. Confidential information from other taxpayers may be reviewed for general information or suggestions for further investigation. However, using such information to establish comparables will be a problem. Secret comparables are discussed in detail at 3.6.7.

14.3.11.2 The attorney-client privilege and the work product doctrine are well developed in the United States and other countries, although such privilege and doctrine may not exist or be so developed in other countries. The attorney-client privilege protects the confidentiality of communications between the client and the attorney or the attorney's agents. Where legal advice is sought from a lawyer, the communications relating to that purpose made in confidence by the client are protected from disclosure by the client or by the lawyer unless the protection is waived by the client.

14.3.11.3 The attorney work product doctrine protects materials prepared for trial or in anticipation of litigation by an attorney or the agent of the attorney. When litigation is reasonably anticipated in relation to the transfer pricing examination, the due consideration of the attorney-client privilege and the work product doctrine would be important, where they are applicable.

14.3.12 Comparison Chart

14.3.12.1 In the process of examination, it may be useful to prepare a comparison table of the tested party and potential comparable(s). A simple example of a comparison is shown in Table 14.T.1 below.

Table 14.T.1
Comparison Chart

	Tested Corporation	Comparable Corporation
Industry code		
The last day of accounting period		
Contents of business		
Principal products handled		
1. _______________(__%)		
2. _______________(__%)		
3. _______________(__%)		

Table 14.T.1
Comparison Chart (continued)

	Tested Corporation	Comparable Corporation
Principal vendors		
Principal purchasers		
"Home-grown" R&D		
No. of employees		
Territory		
Paid-up capital		
Amount of borrowing		
Sales (five years)		
Gross profits and margins (five years)		
Operating profits and margins (five years)		
Gross profit margins after adjustments		

14.4 Narrowing of Issues: Development of Tax Authority's Position

14.4.1 Refining Understanding of the Taxpayer's Business

14.4.1.1 During the examination process the examination team needs to review information it has obtained concerning the taxpayer's business in the light of responses to information requests and other information gathering activities. This will lead to a refined understanding of the taxpayer's business and such information will affect the choice of potentially comparable transactions or companies and of the most appropriate transfer pricing method.

14.4.2 Refining Understanding of the Taxpayer's Industry

14.4.2.1. Similar efforts will be needed in refining the understanding of the taxpayer's industry. The examination team would typically review additional information, including, for example, product line financial statements for multiple years to detect unusual fluctuations or deviations from industry norms that may not result from business or product life cycles.

14.4.3 Refining Functional Analysis

14.4.3.1 The examination team will need to accurately delineate the tested transactions, including understanding the relevant functions, assets and risks before attempting to find appropriate comparables or evaluating the taxpayer's choice of transfer pricing method. The examiners will need to identify the economically relevant characteristics of the transaction, focusing on those that are most important in creating value. The examiners use information obtained in information requests and interviews to trace and understand the flow of transactions.

14.4.3.2 The examiners will need to determine the effect of any unique and valuable intangibles on the transactions. As higher risk justifies a higher expected return, the examination team will need to consider the economically significant risks in relation to the tested transaction(s). Such risks might include market risks (arising from fluctuations in cost, demand, pricing, etc.), foreign exchange risks, credit and collection risks, product liability risks and general business risks.

14.4.3.3 Once the relevant transactions have been accurately delineated, the examiners will seek to identify comparable uncontrolled transactions (or more often, uncontrolled companies engaged in such transactions). The taxpayer will typically seek to participate in this step to ensure that only appropriate comparables are used. See further Chapters 3 and 4.

14.4.4 Choice of Transfer Pricing Method

14.4.4.1 After accurately delineating the transaction, the most appropriate transfer pricing method should be selected. See further Chapter 4.

14.4.5 Examiners' Interim Opinion or Preliminary Position Paper

14.4.5.1 Toward the end of the examination procedure, the examination team often produces a written report or interim opinion; unless the examiners judge that no adjustment should be made. It is often helpful to resolve factual issues important to the analysis or agree to disagree on certain issues while the information is fresh rather than delaying the resolution until the end of the examination process. This will help to narrow the scope of any points of disagreement as much as possible.

14.4.5.2 The taxpayer may challenge the report or opinion, suggest modifications, or accept the report as accurate.

14.4.6 Draft Proposed Adjustments

14.4.6.1 When the examination team considers that it sufficiently understands the transfer pricing issues and has concluded discussions with the taxpayer, it may set out the proposed adjustments, if any. In some countries, the proposed adjustments may be combined with the examiners' interim report described above.

14.4.6.2 This will, in some jurisdictions, be the last chance for the taxpayer to determine whether or not to reach a settlement with the examination team.

14.4.7 Formal Notification to Taxpayer of Proposed Adjustment

14.4.7.1 Unless the taxpayer and the examination team can reach agreement, the formal notification of the proposed adjustment will be issued.

14.4.7.2 In some countries, the issuance of a formal notification of proposed adjustment is required and the taxpayer is given the opportunity to accept the notification within a stipulated time (for instance, 30 days) and/or notify of any set-offs.

14.4.8 Issuance of Adjustment/Correction

14.4.8.1 The final step in the audit process is the issuance of an adjustment notice (i.e. a notice of deficiency). In some countries this final notice of correction may be issued without going through the formal notice of proposed adjustment, while in others the process may include such notice. The issuance of the adjustment notice may also trigger a requirement for the taxpayer to pay the additional tax owing within a certain period.

14.4.8.2 Appeal and dispute resolution mechanisms will typically apply thereafter; see further Chapter 15. Suspension or postponement of the collection of the additional tax liability may also apply, depending on the domestic rules of the country concerned.

14.4.9 Settlement Opportunities

14.4.9.1 There should be the opportunity for settlement with the examination team throughout the process of the transfer pricing examination. Appropriate planning and documentation combined with active involvement in the examination process may facilitate a settlement with the examination team.

14.4.9.2 Settlement processes may be explicitly provided for in the transfer pricing rules, or applied through a broader system of tax dispute settlementThe Mutual Agreement Procedure and other aspects of dispute settlement are addressed in Chapter 15 of this Manual.

14.5 Case Closure

14.5.1 The case closure needs to be properly documented, as every decision taken can potentially be subject to litigation. The table below provides a clear documentation process to ensure the information needed is recorded and to guarantee that the required process has been followed. The audit report is also captured in the table with all the required details.

14.5.2 **Audit Closure Template**

Table 14.T.2
Audit Closure Template

Audit team:		Date:
Taxpayer name:	Tin:	
	Tax period:	
Physical address:	Audit type:	
Date of commencement:	Date of completion:	

Taxpayer's nature of business & main activities:				
Members of audit team				
Name		Designation	Employee id. No.	
1				
2				
3				
4				
5				

Tax types covered	Tax periods audited

1. Audit objective

2. Audit Scope

3. Risks identified at profiling and planning stage

4. Risks identified during audit execution

5. Records reviewed and audit methodology used (work done)	Cross reference to working papers
❑ ❑	

6. Audit findings i.E. Observations on compliance (accuracy, completeness and validity)	
❑ ❑ ❑ ❑	

7. Summary of revised adjustments/assessments and tax payable						
Tax type	Period audited	Revised tax	Penalty	Interest	Tax paid	Tax due

7A. Summary Of Losses Carried Forward/ Unabsorbed Capital Allowances Relieved		
Year	Loss C/F Relieved	Unabsorbed C/A Relieved
2014		
2015		
2016		
2017		
2018		
2019		

8. Taxpayer's Bank Account(S) Details	
Bank Name	Account Number

9. Taxpayer concurrence, recommendations, or commendations

10. Internal recommendations (exclude from the taxpayer's copy of audit report)

11. Challenges encountered and limitations to the audit

12. Observations by level supervisor
Name, signature and date

13. Observations by team leader			

14. Endorsement by members of the team			
Name	Designation	Signature	Date

14.6 Tax Audits and Dispute Resolution

14.6.1 Certain aspects of transfer pricing audits (and tax audits in general) are relevant in the context of dispute resolution. Understanding how tax audit practices, audit settlements and joint audits may be useful in avoiding and resolving tax disputes is crucial for tax administrations and taxpayers. These issues are discussed at Chapter 15.

15 Dispute Avoidance and Resolution

15.1 Introduction

15.1.1 Dispute avoidance and resolution procedures are essential to the effective and efficient functioning of all tax administrations. Such procedures, if well designed and implemented, can enable fair and efficient resolution of differences between tax administrations and taxpayers regarding interpretation and application of transfer pricing rules.

15.1.2 The goal of dispute avoidance and resolution procedures is to facilitate the efficient and equitable determination and collection of tax revenues that are properly due. Ideally, this determination and collection should be done in ways that minimize controversy, cost, uncertainty and delay for both tax administrations and taxpayers. The most efficient method of addressing disputes is to prevent them from arising. Tax administrations should therefore first focus on avoiding disputes; they should also ensure that appropriate dispute resolution procedures are available should they become necessary.

15.1.3 In the cross-border context, dispute avoidance and resolution procedures are particularly important to avoid double taxation of the same income for a taxpayer or for associated enterprises. These procedures can also help avoid the imposition of tax not in accordance with the provisions of the applicable tax treaty, if any. When a tax treaty applies, both tax administrations involved in a tax dispute should give effect to the provisions of that treaty. They should also provide rules and procedures for departing from the domestic law result where necessary to resolve disputes in accordance with relevant tax treaty provisions.

15.2 Special Considerations for Developing Countries

15.2.1 The number of Mutual Agreement Procedure (MAP) disputes worldwide has been rising rapidly according to the MAP data published by the OECD available at the OECD website.[129]

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129 The most recent report is the OECD's Mutual Agreement Procedure Statistics for 2019. Available from https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics.htm.

15.2.2 However, tax administrations often face resource limitations regarding the handling of (cross-border) tax disputes and such limitations may be even greater for the tax administrations of many developing countries. Such limitations may affect staffing levels, training budgets, access to commercial databases needed for transfer pricing analyses and other research materials, access to outside experts, travel funding and other factors. It should be recognized that such resource limitations may put tax administrations at a real (or perceived) disadvantage when dealing with better-resourced administrations. It is thus particularly important for developing countries to ensure that dispute avoidance and resolution procedures are designed to operate as efficiently as possible. Efficient dispute avoidance and resolution procedures should benefit taxpayers as well. Access to properly functioning dispute avoidance and resolution procedures is particularly important for multinational enterprises as they are called on to comply with tax laws and reporting requirements of multiple countries and may need to address any audits or disputes that may arise in any of the countries where they do business.

15.2.3 There are various administrative procedures that could be applied to minimize transfer pricing disputes and to help resolve such disputes when they arise between taxpayers and their administrations, and between different tax administrations. Where two or more tax administrations take different positions in determining arm's length conditions, double taxation may occur. This means that the same income is included in the taxable base by more than one tax administration. Double taxation is undesirable and should be eliminated wherever possible as it constitutes a potential barrier to international trade and investment flows.

15.2.4 This chapter discusses several approaches to resolving disputes arising from transfer pricing adjustments and for avoiding double taxation. The respective procedures all call upon domestic tax administration resources. If resource mobilization is a key concern or limiting factor for a country's tax administration, it should consider the approaches that can be realistically made available, are appropriate, and the provision of the investments in facilities that may be required to expand the available dispute resolution procedures.

15.3 Dispute Avoidance Procedures

15.3.1 Legislation and Guidance

15.3.1.1 As in other areas of law, clear guidance in advance regarding any legal transfer pricing requirements that apply can serve to reduce tax disputes. This is equally important both for tax administrations, which need such guidance to apply the law properly and equitably, and for taxpayers, which must comply with the law. Clear guidance can help avoid unexpected results and therefore help minimize controversy.

15.3.1.2 Guidance can serve these purposes only if it is clear and detailed enough to be properly understood by both tax administrations and taxpayers. Countries that have adopted transfer pricing legislation have to strike various balances between the provision of general principles and detailed rules in that legislation and accompanying guidance. Where general principles are preferred it is often advisable, for the sake of clarity, to supplement them with examples illustrating their application.

15.3.1.3 As described in Chapter 10, developing countries seeking to adopt transfer pricing legislation or revise existing legislation generally base such legislation on the arm's length principle, which is adopted in both the UN and OECD Model Conventions and in most national legislation throughout the world. As long as this remains the case, departures from the arm's length principle will create an increased risk of double or unexpected taxation, with no realistic prospect of cross-border relief. This could make the costs of doing business in the country concerned prohibitive and discourage cross-border trade and investment, with negative effects on sustainable development. While it is for each country to determine its own tax system, the desire to avoid double taxation has been an important factor in the broad acceptance of the arm's length principle internationally.

15.3.1.4 Developing countries whose tax systems are at an early stage of development or who face severe resource constraints may choose, for practical reasons, to adopt an approach to transfer pricing that is simplified in comparison to that adopted by more developed countries and recommended by the OECD Transfer Pricing Guidelines. Where a simplified approach is adopted care should be taken, for the reasons noted above, to avoid results that depart from the arm's length principle. Where a country decides to adopt a simplified approach, it may be advisable to re-evaluate that decision periodically. A simplified approach may not continue to meet the needs of the tax administration as it addresses more complex transactions, or the approach may no longer be needed for practical reasons.

15.3.1.5 The setting of legislative priorities is obviously a matter for each country to decide for itself, in view of its particular circumstances and policies. Transfer pricing legislation may, for example, not be seen as a first priority by developing countries whose tax systems are still in a relatively early phase of legal development, especially if cross-border trade and investment are not yet significant in volume.

15.3.1.6 However, where a country that has not adopted specific transfer pricing legislation decides that it is appropriate to challenge a company's inter-company pricing it may find that it lacks a clear legal basis for such a challenge. While some countries may have general legal provisions or principles, such as general anti-avoidance rules or substance-over-form doctrines, they may find it difficult to successfully challenge inter-company pricing on this basis as transfer pricing is a specific fact oriented tax issue.

15.3.1.7 Such an approach may also raise issues of fairness to the taxpayer, if the application of general principles to inter-company pricing is not sufficiently clear and predictable. In such a case, this lack of certainty may create significant controversy.

15.3.1.8 Due to the above-mentioned considerations it is normally advisable for developing countries to adopt transfer pricing guidance as soon as they are in a position to do so and to examine transfer pricing practices to the extent possible.

15.3.2 Formalized Processes and Practices

Tax Audit Practices

15.3.2.1 Tax audit practices and policies play a key role in any effort by a tax administration to avoid or minimize disputes with taxpayers. To the extent that a tax administration's audit practices and policies are seen as fair and are implemented equitably it becomes less likely that taxpayers will see a need to pursue dispute resolution options.

15.3.2.2 Conversely, where a tax administration has systematic integrity or confidentiality issues or applies the law in a manner that is not seen as fair and equitable, or is regarded as unpredictable, taxpayers are more likely to see a need to seek resolution of the dispute elsewhere. All tax administrations seeking to avoid or minimize disputes with taxpayers should therefore devote significant attention to the operation of their tax audit practices and policies. Issues relating to tax audits are discussed in more detail in Chapter 14.

Advance Tax Rulings

15.3.2.3 Some countries have a practice of issuing advance rulings regarding the application of a country's laws to a taxpayer's particular facts (sometimes structured as unilateral Advance Pricing Agreements (APAs) in some countries — discussed in more detail below in the section on cross-border dispute avoidance procedures); see further 15.3.4. These advance determinations can often be very helpful in avoiding disputes between that taxpayer and the tax administration.

15.3.2.4 When considering new issues tax administrations may initially prefer to provide guidance by a system of case-specific rulings so that they have an opportunity to consider the issues more fully before committing themselves to a general approach. On the other hand, where the issue is one of general application it may be more efficient for the tax administration to issue general guidance.

15.3.2.5 A heavy reliance on ad hoc rulings may also give rise to integrity concerns and associated equity issues unless there is a robust ruling review process in place. Where guidance is routinely provided by way of rulings it may prove difficult to strike an appropriate balance between legitimate taxpayer confidentiality concerns and the level of transparency that may be desired to issue an effective ruling.

15.3.2.6 While it is generally best practice to maximize transparency, it would normally be inappropriate for the tax administration to publish case-specific rulings in their entirety as this would risk divulging sensitive taxpayer information to competitors. Many countries have a policy of publishing rulings after removing sensitive taxpayer information; this approach may however effectively disclose the identity of the taxpayer if these taxpayers operate in smaller markets, with negative consequences for the taxpayer's competitive position. It may therefore make sense for tax administrations to use case-specific rulings primarily to provide guidance on issues that are unique, novel or particularly difficult, or as an interim measure, while adequate published guidance is being developed.

15.3.2.7 An alternative means of promoting transparency and consistent treatment of taxpayers, reportedly used by Nigeria, for example, is to publish generally applicable guidance on issues of broad application after analyzing them in a cooperative relationship process with a particular taxpayer. Another possibility would be consultation processes with the business or industry sectors involved.

15.3.2.8 Some countries publish redacted copies of advance rulings in order to give guidance on current interpretations of the law as well as to provide transparency. In the case of unilateral advance rulings (including unilateral APAs) it should be noted that Inclusive Framework members are required to notify the affected state(s).

Cooperative Compliance Relationships

15.3.2.9 In addition, tax administrations may wish to consider whether they should move towards a more cooperative relationship (sometimes referred to as an "enhanced relationship") with some taxpayers and their advisors in order to get a better understanding of their business and transfer pricing practice. The Netherlands and the United Kingdom are widely seen as having already successfully implemented cooperative relationship programmes and other countries (such as Nigeria) are currently testing this approach.

15.3.2.10 A cooperative relationship can benefit tax administrations and taxpayers by offering greater certainty and transparency, an earlier and more efficient discussion on and resolution of any tax issues and lower administrative and compliance costs. It can also be used to resolve tax disputes or uncertainties for prior years more efficiently.

15.3.2.11 From a tax administration perspective, interest in a cooperative relationship follows from the understanding that:

- Effective risk management requires current, relevant and reliable information regarding the taxpayer's facts and potential tax issues, for which the taxpayer is the best source;
- A cooperative relationship makes the collection of any taxes owed more efficient, saving audit and litigation resources; and
- Tax payments will be received more quickly if disputes are avoided or resolved early in the process.

15.3.2.12 From the taxpayer's perspective, a cooperative relationship may be worthwhile because it can:

- Provide greater certainty and predictability regarding the taxation of the taxpayer, which is essential especially where significant investments are being considered;
- Expedite the resolution of tax issues; and
- Save costs by streamlining compliance and dispute resolution processes.

15.3.2.13 A cooperative relationship initiative tends to be administration resource intensive, however, and must be carefully implemented to ensure the consistent application of legal provisions, to protect taxpayer rights and to avoid integrity issues. While the manner in which tax administrators, taxpayers and tax advisors deal with each other is modified, applicable tax provisions should continue to be applied impartially. It is also important to implement cooperative relationship initiatives efficiently so that adequate audit resources can be devoted to less compliant taxpayers.

15.3.2.14 Development of a successful cooperative relationship requires that all parties engage on the basis of the following parameters:

- A genuine commitment to developing a relationship of mutual trust;
- A transparent and open approach;
- An understanding of commercial and industry aspects;
- An implementation process agreed at the start, including the designation of responsible persons at relevant levels of both the tax administration and the taxpayer; and
- Clear agreement in advance on the period to be covered.

15.3.2.15 Tax administrations may find it useful to adopt an industry-based focus where feasible, so that the experience gained can be leveraged and used to provide consistent and transparent treatment to similarly situated taxpayers (taking relevant differences into account).

15.3.3 Audit Settlements

15.3.3.1 Many tax administrations, both in developing and developed countries, rely heavily on case-by-case audit settlements to resolve disputes with taxpayers. To the extent audit settlements are based on clarifications and better understandings of relevant facts, this may be an effective use of limited resources.

15.3.3.2 A disadvantage of audit settlements is that such settlements are often not very transparent, they are not necessarily coordinated to provide similar treatment to similarly situated taxpayers, and they are therefore not always perceived as being fair by stakeholders. Audit settlements may also raise more integrity concerns than some other dispute settlement procedures.

15.3.4 Advance Pricing Agreements/Arrangements

15.3.4.1 Multinational businesses have often relied on Advance Pricing Agreements (APAs) (or "Advance Pricing Arrangements", as some countries prefer) with tax authorities, especially in the framework of the Mutual Agreement Procedure. APAs are so named because pricing methodologies are agreed in advance in relation to certain types of transactions, often called the "covered transactions". APAs provide greater certainty for the taxpayer on the taxation of certain cross-border transactions and are considered by the taxpayers as the safest way to avoid double taxation, especially where they are bilateral or multilateral. The possible advantages and disadvantages of APAs for developing country administrations and taxpayers, including some implementation issues, are addressed below.

15.3.4.2 APAs were initially created by the National Tax Agency of Japan in 1987. Agreements reached with taxpayers under the pre-confirmation system were unilateral in nature. In 1991, the IRS of the United States introduced APAs. The APA introduced by the IRS could be bilateral in nature, utilizing the MAP provided in the applicable tax treaties to reach bilateral or multilateral agreements.

15.3.4.3 APAs have been introduced in many countries. When APAs are bilateral or multilateral, they confirm the arm's length result in advance by agreement between taxpayers and tax authorities in the relevant countries. They define agreed outcomes on certain sets of criteria (transfer pricing methods, comparables and appropriate comparability adjustments, critical assumptions as to future events, etc.). APAs are adopted not only by OECD member countries, but also by non-OECD countries. The OECD Transfer Pricing Guidelines strongly endorse bilateral and multilateral APAs as a supplement to the traditional administrative, judicial and treaty mechanisms for resolving transfer pricing issues.[130]

15.3.4.4 Some countries also issue unilateral APAs. These unilateral APAs only involve the tax administration in one country and are therefore categorized as only partial solutions for double taxation. Unilateral APAs can be considered useful in specific cases depending on all the facts and circumstances, but they usually do not provide a full solution to the problem of double taxation.

15.3.4.5 One of the key advantages of adopting an APA system is that uncertainty can be eliminated through enhancement of predictability of the taxation of international transactions. Developing countries thus have a good opportunity to obtain access to existing documentation which is relevant to their local operations. A second advantage is that APAs can provide an opportunity for both tax administrations and taxpayers to consult and cooperate in a non-adversarial spirit and environment. Thirdly, an APA may prevent costly and time-consuming examinations and litigation of major

[130] OECD (2017). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Paris: OECD Publishing. Available from https://doi.org/10.1787/tpg-2017-en. See para. 2.21, section on commodity transactions. See paras. 4.134 to 4.176 and Annex II to Chapter IV. See additionally, Guidelines of the same document: Guidelines for Conducting Advance Pricing Arrangements under the Mutual Agreement Procedure (MAP APAs).

transfer pricing issues for taxpayers and tax administrations. Fourthly, the disclosure and information aspects of an APA programme, as well as the cooperative attitude under which an APA can be negotiated, may assist tax administrations in gaining insight into complex international transactions undertaken by MNEs.

15.3.4.6 Tax administrations generally find APAs to be a more amicable process than the audit process followed by MAP. To the extent that there is advance agreement on key transfer pricing issues neither country faces the prospect of refunding taxes already collected. Furthermore, as the taxpayer provides extensive information in advance, the APA process is usually efficient in determining relevant facts. Perhaps for this reason many tax administrations have a general practice of suspending examination activity during APA discussions. Tax administrations may wish to clarify in their APA procedures that all information pertaining to the APA request should be shared simultaneously with both countries.

15.3.4.7 Tax administrations have also found APAs to be useful tools for developing a deeper understanding of business operations, which can be used to inform their general guidance and examination processes. Most tax administrations have found that APAs are more widely embraced if APA and examination functions are kept separate. Alternatively, they may impose limitations on the use of some or all of the information provided by the taxpayer in the APA discussions for other purposes such as subsequent examinations or future litigation if an APA cannot be successfully concluded.

15.3.4.8 Tax administrations with severe resource limitations may wish to weigh the advantages of APAs against other resource needs. It may be difficult for a tax administration that is still developing its general audit capabilities to feel comfortable diverting substantial resources to an APA programme at that stage. Such countries may also be concerned that they will be at a disadvantage in negotiating APAs with MNEs or more experienced countries until they develop more experience, including experience with MAP cases. On the other hand, APAs can be useful on an interim basis as an efficient means of collecting tax in the short term, particularly in countries with a small number of large foreign investors. An APA can conserve resources but cannot replace the need for trained audit staff, so it can be beneficial for training to proceed in parallel while outside technical assistance and APA expertise is available.

15.3.4.9 Countries with limited experience in applying a transfer pricing regime may initially prefer to limit the terms of their APAs; they can then evaluate the experience more quickly and adjust their practices as needed. A term of perhaps three years could be applied, rather than the five years more commonly used by experienced countries. Alternatively, they may wish to negotiate a few APAs in a pilot programme before committing themselves to a generally available, permanent programme.

15.3.5 Developing and Operating an APA Programme

15.3.5.1 It is important to establish an appropriate operational framework for an APA programme, to promote a consistent, principled approach and to ensure adequate review. Ideally, APA programmes should be established with a special unit comprised of trained staff designated only for that function. This would maximize the benefits of experience and promote an attitude of cooperation and transparency. If, due to resource limitations, APA programmes need to draw on expertise from other parts of the tax administration, it is important to establish safeguards to ensure that the APA process is not managed in the same way as a typical audit. Failing to do so may result in the loss of many of the benefits typically enjoyed by tax administrations in APA proceedings.

15.3.5.2 At the same time, it is important to ensure that the APA programme operates in an appropriate manner within the framework of the tax administration as a whole. Procedures should be set up, for example, to prevent the APA programme from being used primarily to challenge the position of an audit team for past years. This may be achieved by requiring that the APA applies primarily to future years rather than past years. Organizationally, most tax administrations have tended to manage their APA programmes together with their MAP programmes and to organize them so that all cases with a particular treaty partner are handled by the same team. This facilitates the formation of closer working relationships between the teams from the two countries and promotes a better understanding of the other country's economy, legal provisions and administrative procedures. On the other hand, benefits may also be derived by comparing experiences on different cases within an industrial sector or by comparing the approaches of various treaty partners to similar issues. It is also important to establish procedures to facilitate the sharing of such knowledge, to strengthen technical analysis and to provide consistent treatment.

15.3.5.3 Most tax administrations have found that an APA term of approximately five future years strikes the best balance between efficient use of resources and the uncertainties associated with prospective agreements. The risks associated with uncertainties can be minimized by specifying critical assumptions, based on which the APA will be renegotiated if necessary. It is fair to expect a renegotiation of the APA if the applicable law or the covered transactions change materially, but care should be taken not to impose excessively strict requirements on the continued application of an APA.

15.3.5.4 A tax administration's resources are normally best used to conclude APAs on complex issues. However, in the interest of fairness to smaller taxpayers who also need certainty, tax administrations may wish to consider establishing special simplified APA procedures for SMEs. A 2011 OECD survey of OECD member and observer countries found that a number of countries have adopted simplified measures for SMEs (see 11.4.3.3), small transactions and/or low value-added services and that Canada, France, Germany, the Netherlands and the United States have simplified APA procedures for SMEs. These programmes generally require SME taxpayers to provide less information and may also lower the application fee, if there is one.[131]

15.3.5.5 Some administrations charge taxpayers user fees for the conclusion of an APA, as a means of funding the programme. If reasonable in amount, these fees have generally been accepted by taxpayers as outweighed by the advantage of the certainty provided by the APA. To avoid integrity issues, it is important that the fees be charged on a consistent basis (ideally reduced for small taxpayers), that they are paid into government funds and that they are refunded in the rare circumstances where an APA cannot be concluded. The Guide to the Mutual Agreement Procedure under Tax Treaties provides more guidance on best practices in the structuring and operation of APA programmes, and was approved by the Committee in October 2012.[132] Tax administrations may also want to refer to the Manual on Effective Mutual Agreement Procedures,[133] the Guidelines for Conducting Advance Pricing Arrangements under the Mutual Agreement Procedure (MAP APAs) in Annex II to Chapter IV of the OECD Transfer Pricing Guidelines,[134] and to the work of the EU Joint Transfer Pricing Forum on dispute resolution and APAs.[135] Finally, some national tax administrations, including those

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131 OECD Transfer Pricing Country profiles. Available from https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profiles.htm

132 UN (2012). *Guide to the Mutual Agreement Procedure Under Tax Treaties.* New York: UN Publishing. Available from https://www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-Guide_MAP.pdf

133 OECD (2007). *Manual on Effective Mutual Agreement Procedures (MEMAP).* Paris: OECD Publishing. Available from https://www.oecd.org/tax/dispute/manualoneffectivemutualagreementproceduresmemap.htm.

134 OECD (2017). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.* Paris: OECD Publishing. Available from https://doi.org/10.1787/tpg-2017-en

135 *EC (2007). EU Joint Transfer Pricing Forum in the Field of Dispute Avoidance and Resolution Procedures and on Guidelines for Advance Pricing Agreements within the EU.* Brussels: EC. Available from https://ec.europa.eu/taxation_customs/system/files/2016-09/sec%25282007%2529246_en.pdf

of Canada, India,[136] Japan, the United Kingdom[137] and the United States[138] have published detailed internal APA procedures. These may also provide useful comparative information.

15.3.6 Joint Audits

15.3.6.1 Developing countries may also want to consider participating in joint audits. These are conducted by two or more tax administrations together to share information, save resources and minimize or expedite the resolution of controversies.

15.3.6.2 Joint audits are still relatively new procedures, but they may prove useful for developing country tax administrations with fewer resources and less experience or subject-matter expertise in the industry or issues concerned. On the other hand, issues such as different languages, authority to access foreign taxpayer information and differing accounting years and audit cycles may need to be addressed.

15.4 Domestic Dispute Resolution Procedures

15.4.1 Administrative Appeals

15.4.1.1 A well-designed administrative appeals procedure can help ensure that the tax administration resolves its disputes with taxpayers in an efficient and fair manner. This will provide an added level of assurance to investors. To operate well and to be perceived as fair, an appeals procedure must be independent of other parts of the tax administration, so that it can provide an independent review of the dispute. It may not be as effective, from an institutional perspective, to have the case heard by the persons responsible for issuing the assessments or by their peers.

15.4.1.2 Countries seeking to avoid integrity issues may wish to consider using panels of decision-makers, as in India's Dispute Resolution Panel programme, or implementing additional levels of reviews, as in Nigeria's rulings practice. Brazil's Administrative Court of Tax Appeals (CARF) is an example of a successful administrative appeal procedure. Appeals are processed in three steps, the first step being within the tax administration

[136] http://www.itatonline.org/info/index.php/cbdts-advance-pricing-agreement-guidance-with-faqs/

[137] https://www.gov.uk/hmrc-internal-manuals/international-manual/intm422010

[138] http://www.irs.gov/pub/irs-drop/rp-06-9.pdf.

while the second (the appeal) and the third (the special appeal, which is accepted under certain conditions) are decided by the CARF. The CARF is housed within the Ministry of Finance but is separate from the tax administration, even though that is part of the same ministry.

15.4.2 Mediation/Conciliation

15.4.2.1 Mediation and conciliation are sometimes mentioned as potential procedures to resolve disputes. Mediation has proven successful in resolving tax disputes within developed economies. The most significant benefit of this approach towards dispute resolution is seen as the quick time frame within which disputes have been resolved. The mediation option may be made available as an administrative process within the tax administration, rather than as a separate independent mediation procedure outside of the administrative process.

15.4.2.2 The process may be particularly promising in those situations where the tax auditor and taxpayer are no longer willing to communicate with each other and mutually resolve a dispute. In this environment, a mediator may be able to help overcome relationship challenges that prohibit the parties from reaching an agreement. While it may be worth testing these approaches, it should be noted that they are not automatically effective in a cross-border context, as they would still require an additional administrative step to obtain avoidance of double taxation. Potential utilization of similar processes in the treaty dispute resolution process is noted at 15.5.6 below.

15.4.3 Judicial System

15.4.3.1 An independent judicial system that provides a forum for unbiased consideration of disputes, including tax disputes, can do much to improve a country's reputation among investors as a jurisdiction where tax disputes can be fairly resolved.

15.4.3.2 However, owing to the call in the modern business world for real-time certainty regarding tax obligations, the perceived benefit of such a judicial system declines as the length of time to obtain a final decision grows. It is therefore important to ensure that the judicial system has adequate resources and that it is not unduly burdened by tax disputes due to real or perceived deficiencies at the audit and administrative appeals stages.

15.5 Dispute Resolution Procedures: Tax Treaty Provisions

15.5.1 Division of Taxing Jurisdiction

15.5.1.1 Tax treaties significantly reduce the scope for cross-border disputes. Without a tax treaty, income from cross-border transactions or investment is subject to potential double taxation whenever the laws of the source and residence countries differ. Tax treaties seek to eliminate this double taxation by allocating between the contracting states the taxing jurisdiction over such income and by providing procedures for the relief of any residual double taxation. Treaties also typically require tax laws to be applied without discrimination based on nationality or capital ownership and without discrimination against the conduct of business through a permanent establishment.

15.5.1.2 Treaties therefore offer significant reassurance and certainty to potential investors, as well as greater certainty for tax administrations, by reducing the risk of cross-border disputes. In considering whether to make the negotiation of tax treaties a priority and which treaty negotiations to prioritize, developing countries may wish to weigh these advantages against the resources and the balance of bilateral concessions required to achieve an agreed treaty.

15.5.2 The Mutual Agreement Procedure

15.5.2.1 Tax treaties also provide for the MAP, a cross-border dispute resolution procedure under Article 25 of both the UN and OECD Model Tax Conventions. The MAP is operated by designated tax administration officials of each country who are referred to as "competent authorities", and it enables tax administrations to reach bilateral agreement on issues of general interpretation or application and to thereby avoid double taxation on cross-border transactions and the resulting disputes. The MAP is separate from, and additional to, domestic law remedies for dispute resolution. However, in many countries domestic law (and in particular a final court decision) can limit available solutions under the MAP.

15.5.2.2 The MAP agreements may relate only to the assessments made in past years, or they may take the form of APAs that provide for agreement on a transfer pricing methodology for future years (and in many cases past years as well) as explained in 15.3.5. The MAP also applies to resolve cross-border disputes that have arisen in particular cases.

15.5.2.3 The UN Commentary on Article 25 (Mutual Agreement Procedure) provides useful guidance on dispute resolution through the MAP, which is relevant for both transfer pricing and other tax disputes. The UN Committee of Experts on International Cooperation in Tax Matters (UN Committee) has adopted a Guide to the Mutual Agreement Procedure under Tax Treaties, which provides additional guidance on best practices in the structuring and operation of MAP programmes based on practical experience, which developing countries may wish to evaluate and draw upon.[139]

15.5.2.4 Some tax administrations, including for example those of Canada,[140] Germany, India, Japan,[141] the Netherlands, the United States[142] and the United Kingdom,[143] have published detailed internal MAP guidance. These may also provide useful comparative information for tax administrations that wish to learn more about the MAP. It is useful for tax administrations to indicate their intention to follow published guidelines or to publish their own MAP guidance. This promotes consistency in case handling and transparency regarding the expectations of the tax administration. It may be advisable to enact provisions in domestic law allowing for MAP and APA procedures and, if necessary (and possible), an amendment to the constitution, in order to provide juridical certainty to such procedures.

15.5.2.5 The purpose of a MAP programme is to provide an effective means of reconciling differing positions of treaty partners, so that the treaty can operate as intended to avoid double taxation or other taxation not in accordance with the provisions of the treaty. Experience has shown that this purpose can best be achieved if the MAP programme is structured so that tax administrators implementing the MAP programme are able to make

139 UN (2012). *Guide to the Mutual Agreement Procedure Under Tax Treaties.* New York: UN Publishing. Available from https://www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-Guide_MAP.pdf. Guidance on dispute resolution and avoidance more generally will be made available by the UN Tax Committee in 2021. Tax administrations may also want to refer to the OECD Manual on Effective Mutual Agreement Procedures (MEMAP) available from https://www.oecd.org/ctp/dispute/manualoneffectivemutualagreementproceduresmemap.htm. The aim of the MEMAP is to make available to tax administrations and taxpayers basic information on the operation of the MAP under bilateral tax treaties and to identify best practices for MAP.

140 https://www.canada.ca/en/revenue-agency/services/tax/international-non-residents/competent-authority-services/mutual-agreement-procedure-2014-2015-map-program-report.html

141 https://www.nta.go.jp/english/publication/map_report/index.htm

142 http://www.irs.gov/irm/part4/irm_04-060-002.html.

143 https://www.gov.uk/hmrc-internal-manuals/international-manual/intm422010

decisions independently of those implementing the audit programme and are free from outside influence.

15.5.2.6 Structural independence may be more difficult to achieve in smaller tax administrations, which may have a limited number of subject matter experts available to advise on such issues. Where, because of resource or other constraints, the same experts must be used for both audit and MAP programmes, it will be important to provide a procedure for effective independent review of proposed MAP positions in order to ensure that they are not unduly influenced by the views of auditors.

15.5.2.7 Freedom from political influence on the MAP process is equally important. Many tax administrations have found that this can be best achieved by placing the MAP function within the tax administration, rather than within the Ministry of Finance or other tax policymaking function. Such tax administrations believe it is helpful to establish procedures or practices preventing involvement by those outside the tax administration in decisions regarding particular MAP cases. Other countries believe that placing the MAP function within the Ministry of Finance is preferable, to reduce undue influence by the tax administration, or to facilitate coordination by policymakers.

15.5.2.8 The importance of developing and operating well-functioning MAP processes was recognized and highlighted in Action 14 of the OECD/G20 BEPS Project, resulting in the Action 14: 2015 Final Report *Making dispute resolution mechanisms more effective*.[144] The report contains a number of minimum standards and guidance on best practices some of which are discussed in the Commentary on Article 25 of the UN Model Convention in its 2021 update.

15.5.3 Operational Considerations for MAPs

15.5.3.1 Given their purpose, it is important for MAPs to be operated in a consistent manner rather than handling each case in an ad hoc fashion. This will provide for similar treatment of similarly situated taxpayers and help the MAP programme to be viewed as equitable and effective. Both operational structure and training and other capacity-building of the workforce can play important roles in promoting such consistency. For similar reasons, it is

[144] OECD (2015). *Making Dispute Resolution Mechanisms More Effective, Action 14— 2015 Final Report*. Paris: OECD Publishing. Available from https://www.oecd-ilibrary.org/docserver/9789264241633-en.pdf?expires=1621967277&id=id&accname=guest&checksum=86C8F7CB4AF4AAC1077BDA35019C71D2

important for a MAP programme to apply principled approaches to resolving cases. In the first instance, the approaches taken should be consistent with the provisions of the treaty and any relevant interpretative guidance. It is essential that foreign and domestic taxpayers and "inbound" and "outbound" transactions be treated in the same manner. This will help produce consistent, predictable results and further contribute to a view of the MAP programme as equitable and effective. Training and other capacity-building will also be important.

15.5.3.2 It is also essential to implement a policy of broad access to the MAP, if it is to serve the purpose of resolving cross-border disputes and be regarded by potential investors as equitable and effective. This calls for the elimination of factors that could otherwise prevent or discourage the use of the MAP, including unreasonable time limitations or unilateral attempts to exclude selected issues from the MAP. Consideration should be given to suspending the collection of disputed tax assessments on cases pending in the MAP, as these assessments can otherwise present serious cash flow difficulties for taxpayers that have already been taxed on the same amount in the other country. If necessary, this can be done in exchange for a bank guarantee to ensure the payment of any tax due upon the conclusion of the MAP. Similarly, consideration should be given to preventing the imposition of interest or at least preventing the imposition of higher interest rates that may effectively operate as penalty measures, while cases are pending in the MAP programme.

15.5.3.3 The MAP generally commences with a request by a taxpayer addressed to the designated competent authority of a country for consideration of an issue for dispute resolution and/or relief of double taxation, because the taxpayer believes his tax treatment is not, or will not be, in accordance with the treaty. Alternatively, the process can be initiated because there are questions of interpretation or application of the convention or to eliminate double taxation in cases not otherwise provided for in the convention.

15.5.3.4 The MAP process is intended to be used also to resolve economic double taxation, such as in the case of transfer pricing disputes. The case should be presented to the competent authority of the country where the taxpayer is resident within three years from the (first) time the person is notified (for example by way of a notice of assessment) of the action that will result in taxation not in accordance with the convention. The three-year time limit is determined by the treaty article and may differ in certain cases. The definition of what constitutes (first) "notification" may be provided in domestic regulations. The form of the MAP request to be filed may be prescribed under domestic regulations as well. Alternatively, the commentary to the treaty or the model convention may be consulted in this regard or the OECD Manual on Effective Mutual Agreement Procedures (MEMAP)[145] could also be consulted.

15.5.3.5 Once the MAP request has been received, it needs to be ascertained that the foreign competent authority is properly informed as well and that all relevant information to decide and agree on the matter is made available to both competent authorities. Considering the time limit within which competent authorities are expected to address and resolve a filed request, it is relevant to determine if further information is required from the taxpayer(s) involved or not, and if so, to request this information as soon as practicable. It would not be prudent to wait to ask for this information at the last minute and to extend or overrun the time limit provided by the applicable treaty. The competent authorities may wish to meet in person to compare notes on the matter and to explore available solutions or may wish to handle the matter through (electronic) correspondence or a combination of both of those approaches.

15.5.3.6 It is generally understood that the competent authority of the country that made the primary adjustment leading to the double taxation (or taxation not in accordance with the convention) has the burden of proof towards the other competent authority that the primary adjustment is justified. That competent authority traditionally will send a letter (a so-called position paper) to the other competent authority informing the latter of its position with respect to the issue for which the competent authority request was filed. Based on the position paper, the other competent authority can respond and explore to what extent it agrees with the position and is able to provide for avoidance of double taxation or not.

15.5.3.7 If the competent authorities agree on a way to avoid double taxation and the taxpayer agrees to the suggested solution as well, a bilateral agreement is entered into between the two taxing authorities and an agreement is entered into between the respective competent authority and taxpayer of the country where the primary adjustment was made. Careful consideration is required on how the solution is to be implemented; in what taxable year and whether the statute of limitations is still open as regards that year in the other jurisdiction; or whether the treaty allows for an override of the

[145] OECD (2007). *Manual on Effective Mutual Agreement Procedures (MEMAP).* Paris: OECD Publishing. Available from https://www.oecd.org/ctp/dispute/manualoneffectivemutualagreementproceduresmemap.htm. The aim of MEMAP is to make available basic information on the operation of the MAP under bilateral tax treaties and to identify best practices for MAP. Guidance on dispute resolution and avoidance more generally will be made available by the UN Tax Committee in 2021.

domestic statute of limitation provisions. Consideration should also be given to whether the issue decided is a recurring issue (that applies to later years as well) or not. If the issue is a recurring issue and additional adjustments are to be expected for later years, the taxpayer and competent authorities may wish to explore to what extent they have the authority and means to resolve those years as well, or whether a new MAP request ought to be filed for later years.

15.5.4 MAP Under the Inclusive Framework Initiative

15.5.4.1 In accordance with the mandate of Action 14 of the BEPS Project, the concerned countries worked to "develop solutions to combat the obstacles that prevent countries from resolving disputes related to agreements through [MAP], including the absence of provisions on arbitration in the majority of countries' agreements and the fact that access to mutual agreement procedures and arbitration may be denied in some cases."

15.5.4.2 The measures agreed upon under Action 14 sought to strengthen the effectiveness and efficiency of this procedure by minimizing the risks of uncertainty and unintentional double taxation and ensuring consistent and appropriate implementation of tax treaties.

15.5.4.3 As a result of the final report of this action, a significant number of countries agreed to important changes in their position on dispute resolution regarding tax treaties and the commitment of countries in this regard represents a minimum standard. Through the minimum standard it will be ensured that:

- The obligations of the fiscal treaties related to the MAP are fully implemented, in good faith, and that MAP cases are resolved in a timely manner (in an average of 24 months);
- Administrative processes that promote the prevention and timely resolution of controversies on tax treaties, such as guides for taxpayers about the requirements to access the MAP, are implemented; and
- Taxpayers will have access to the MAP when they are eligible.

15.5.4.4 Being a minimum standard of the Inclusive Framework, the implementation of this commitment by countries is constantly monitored through peer review, which seeks to ensure that all countries that are part of the project comply with this standard.

15.5.4.5 The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Multilateral

Instrument) developed pursuant to Action 15 of the BEPS Project, will facilitate compliance with the Action 14 minimum standard since it allows signatory countries to incorporate into their existing treaties, among other measures, those derived from Action 14 of the BEPS Project, which imply modifications to the Article on MAP. In other words, this Multilateral Instrument will make it possible to modify the existing agreements of the signatory countries, avoiding a large number of bilateral negotiations and the burden that the procedures for signing and ratifying separate amendments to treaties may present.

15.5.5 Arbitration

15.5.5.1 The UN Model Convention provides for optional treaty text that allows the competent authorities to resolve disputes by way of arbitration, if no solution can be obtained within the time frame provided by the mutual agreement article. Competent authorities that cannot find an acceptable solution for a dispute within the requisite time frame must invoke the arbitration procedures if that text is included in the relevant treaty, or agreement exists between treaty partners to resort to arbitration pursuant to that article. The procedures to be followed are those provided by the UN Model Convention or that may have been agreed to by the treaty partners otherwise.

15.5.5.2 Mandatory arbitration provisions have been added to many treaties in recent years as a last resort method of resolving MAP issues that cannot be resolved by the competent authorities within a specified time frame. The European Union began this trend in 1990 with the multilateral EU Arbitration Convention and the OECD amended its Model Convention and Commentary in 2008 to recommend the inclusion of mandatory arbitration provisions in bilateral tax treaties.

15.5.5.3 OECD statistics show that the MAP process succeeds in avoiding double taxation in 90 to 95 per cent of the cases to which its member countries are a party. While that is an impressive success rate for a dispute resolution programme that does not legally require the parties to reach agreement, the risk of double taxation in the remaining cases is still a serious concern for taxpayers and tax authorities, especially given the growing amounts in controversy. Both taxpayers and competent authorities tend to view arbitration very much as a last resort method. However, the inclusion of mandatory arbitration provisions in treaties has been widely supported by taxpayers as they guarantee resolution within a specified time frame and provide certainty that double taxation will be avoided. In the vast majority of cases the practical effect of mandatory arbitration provisions has been to encourage the competent authorities to reach agreement by the specified deadline. Only a handful of cases out of the many hundreds of MAP cases submitted have been taken to arbitration under agreements concluded thus far.

15.5.5.4 Mandatory arbitration provisions have already been added to many treaties between OECD member countries, even where one country has a general preference for residence-based taxation and the other a general preference for source-based taxation. However, the UN Committee has endorsed arbitration only as an option and not as an affirmative recommendation. The envisaged arbitration process is described in the Commentary to Article 25 of the UN Model Convention.

15.5.5.5 As reflected in the UN Commentary on Article 25, members of the UN Committee have identified arguments both in support of and against the adoption of mandatory tax treaty arbitration by developing countries. These arguments are summarized below.

15.5.5.6 It has been suggested that mandatory tax treaty arbitration may have the following potentially negative aspects from a developing country perspective:

- only a small number of cases are submitted to the MAP under paragraphs 1 and 2 of Article 25 and very few of them remain unresolved;
- domestic legal remedies can resolve the few cases that the competent authorities are not able to resolve through the mutual agreement procedure;
- due to the lack of experience with the MAP in many developing countries, arbitration would be unfair to those countries when the dispute occurs with more experienced countries;
- the interests of countries, which are so fundamental to their public policy, could hardly be safeguarded by private arbitrators in tax matters—arbitrators cannot be expected to make up for the lack of expertise in many developing countries;
- the neutrality and independence of possible arbitrators appears difficult to guarantee;
- it is very difficult to find experienced arbitrators;
- mandatory arbitration is costly and therefore not suitable for developing countries and countries in transition; and
- it is not in the interest of a State to limit its sovereignty in tax matters through mandatory arbitration.

15.5.5.7 Those who support the inclusion of mandatory arbitration provisions in tax treaties have argued that these provisions will have certain benefits for developing countries and can be designed in the following ways to address their concerns:

- despite the fact that only a small number of cases remain unresolved, each of these cases represents a situation where there is no resolution for a case where one competent authority considers that there is taxation not in accordance with the Convention and where there may be significant double taxation;
- arbitration provides more certainty to taxpayers that their cases can be resolved under the MAP and contributes to the promotion of cross-border investment;
- domestic remedies may not adequately and rapidly resolve disputes concerning the application of bilateral conventions (risk of inconsistent court decisions in both countries and of unilateral interpretation of the Convention based on domestic law);
- the obligation to submit unresolved cases to arbitration after a given period of time may facilitate the endeavours of the competent authorities to reach an agreement within that period of time;
- on the basis of the experience under the EU Arbitration Convention, the effective recourse to mandatory arbitration should be rather unusual and the costs relating to that mechanism should be low; moreover, as arbitration provides more certainty to the taxpayers, it reduces the number of costly "protective" appeals and uncertain domestic proceedings;
- arbitrators have to reach a well-founded and impartial decision; consequently, they can adjust for the levels of expertise of countries and overcome the possible lack of experience of some countries;
- skilled and impartial arbitrators can be drawn from various backgrounds (government officials, judges, academics and practitioners) and from various regions (including from developing countries); and
- it is in the interest of a State to limit its sovereignty in tax matters through mandatory arbitration.

15.5.5.8 One of the main challenges in the framework of Action 14 was the question of mandatory arbitration as a means to ensure the resolution of disputes. This mechanism gives legal certainty to taxpayers about the resolution of a case in which they consider that a measure not conforming to the agreement was applied. Likewise, it encourages the competent authorities not to postpone the discussion of the case, in order to avoid mandatory arbitration. Notwithstanding the foregoing, most of the countries participating in the BEPS Project have not chosen to include this alternative, with some of the main reasons similar to those addressed above. It should be noted that the arbitration provision can be adopted through the Multilateral Instrument as an option and grants great flexibility with respect to the cases that may be subject to arbitration by allowing countries a reserve mechanism to exclude certain cases from the application of the same.

15.5.6 Non-binding Dispute Resolution Procedures

15.5.6.1 The UN Committee in October 2015 approved the formation of a Subcommittee to address, consider and report back on dispute avoidance and resolution aspects relating to the MAP, with a view to reviewing, reporting on and, as appropriate, considering possible text for the UN Model and its Commentaries, and related guidance, on a variety of issues, including:

- Options for ensuring the MAP under Article 25 (in either of its alternatives in the UN Model) functions as effectively and efficiently as possible;
- Other possible options for improving or supplementing the MAP, including the use of non-binding forms of dispute resolution such as mediation;
- Exploration of issues associated with agreeing to arbitration clauses between developed and developing countries; and
- The need or otherwise for any updates or improvements to the Guide to the Mutual Agreement Procedure under Tax Treaties.[146]

15.5.6.2 On 20 October 2017, the Subcommittee on Dispute Avoidance and Resolution was established and has been discussing dispute avoidance and resolution without focusing on transfer pricing. The work of the Subcommittee will result in a manual on dispute resolution, a useful guide for developing countries on the design and implementation of various dispute resolution mechanisms.

15.6 Multilateral Approaches

15.6.1 Multilateral approaches are important tools to avoid cross-border disputes on transfer pricing and the resulting risks of unrelieved double taxation.

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[146] UN (2012). *Guide to the Mutual Agreement Procedure Under Tax Treaties.* New York: UN Publishing. Available from https://www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-Guide_MAP.pdf

15.6.2 As noted above many countries have historically relied primarily on the guidance provided by the OECD Transfer Pricing Guidelines, which interpret Article 9 (Associated Enterprises) of the OECD Model Convention and have been developed by transfer pricing experts over the past several decades. A number of economies in transition and developing countries have adopted domestic transfer pricing laws that extensively draw upon the provisions of the OECD Transfer Pricing Guidelines. These include, for example, China, Egypt, India, Malaysia and South Africa.

15.6.3 Although the provisions of Article 9 of the UN Model Convention are very similar to Article 9 of the OECD Model, the interpretation provided by the OECD Transfer Pricing Guidelines may not be fully consistent with the policy positions of all developing countries. However, in recent years, representatives of China, India, and other non-OECD economies have begun participating actively as observers in the development of transfer pricing guidance at the OECD level. Non-OECD/G20 countries also participated on an equal footing in the revision of OECD transfer pricing guidance as participants in the OECD/G20 Inclusive Framework initiative.

15.6.4 The Commentary to Article 9 of the UN Model as revised in the 2017 update also recognizes the importance of maintaining a common understanding of how the arm's length principle should be applied in order to avoid international double taxation of corporate profits. To that end the Committee of Experts considered that the OECD Transfer Pricing Guidelines contain valuable guidance relevant for the application of the two Model Conventions, and consistency with the OECD Transfer Pricing Guidelines has been sought when developing this Manual. Therefore, developing countries may wish to consider the relevance of the OECD Transfer Pricing Guidelines, along with the growing body of UN guidance and other available sources, when establishing their own domestic and cross-border policies on transfer pricing.

15.7 Coordination of Domestic and Cross-Border Dispute Resolution Procedures

15.7.1 Each country will have its own domestic dispute resolution procedures in addition to cross-border procedures. It is important that these be properly coordinated for two reasons.

15.7.2 First, tax administrations, especially developing country administrations with limited resources, may want to minimize duplication of effort by avoiding the simultaneous operation of two parallel dispute resolution processes. Most tax administrations prefer to deal with an issue either through the MAP or through domestic procedures, but do not generally operate both procedures simultaneously (with the exception of certain simultaneous MAP and domestic appeals programmes).

15.7.3 Second, notwithstanding such resource concerns, it is important to manage any duplication issues without forcing taxpayers to make a premature choice between domestic and cross-border procedures. For example, taxpayers should not be required to give up their MAP rights under treaties in order to access domestic administrative appeals procedures. To avoid such results, while addressing resource constraints, many tax administrations permit taxpayers to preserve their rights to domestic procedures during MAP discussions by placing them on hold (usually after filing an initial notice of objection) so that they can later pursue their domestic rights if no MAP agreement is reached. Alternatively, tax administrations may wish to provide flexibility in the timing of MAP by not setting a deadline for MAP requests under their treaties or domestic laws, so that appropriate domestic procedures can be explored first. Some tax administrations prefer instead to set a deadline for the filing of a MAP request.

15.7.4 Taxpayers should be permitted, however, to pursue MAP consideration of a relevant cross-border issue or issues while pursuing domestic dispute resolution procedures for separate issues that are not appropriate for the MAP.

15.7.5 In some countries there is a view that the tax administration, including the competent authority, is bound by a final decision of a domestic court and that MAP consideration is not available in such circumstances. Some other countries view this as inconsistent with the obligations of the treaty MAP provisions. Where a competent authority takes the view that it cannot or should not depart from domestic court decisions it should clearly state this position in public guidance for the information of treaty partners and taxpayers.

15.7.6 The competent authority of one country is, of course, not obligated in any way to accept either a court decision or an administrative settlement of another country. The competent authority may however choose to provide relief on a unilateral basis if it agrees with the result reached, but it should not be expected to provide relief solely because it is otherwise unavailable.

Part D

COUNTRY PRACTICES

Preamble by the Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing

In the other Parts of this Manual, the Subcommittee has sought to provide practical guidance on the application of transfer pricing rules based on Article 9(1) of the UN Model Tax Convention and the arm's length principle embodied in that Article. With regard to Parts A through C, the Subcommittee has discussed and debated the merits of the guidance that is provided and, while there may be some disagreement on certain points, for the most part the Subcommittee is in agreement that the guidance in those chapters reflects the application of the arm's length principle as embodied in the UN Model Tax Convention.

The Subcommittee recognizes that individual countries, particularly developing and emerging economies, struggle at times with the details of applying these treaty-based principles in a wide variety of practical situations. It therefore remains appropriate and instructive to allow representatives of individual countries an opportunity to set out their individual country viewpoints and experiences for the information of readers. Those individual country views are contained in this Part.

It should be emphasized that, with this background, this Part of the Manual does not reflect a consistent or consensus view of the Subcommittee. How it should be read is reflected in the Foreword to this edition of the Manual:

> The Foreword to the First Edition of this Manual, remains relevant as to its substance. In particular, its recognition that: "While consensus has been sought as far as possible, it was considered most in accord with a practical manual to include some elements where consensus could not be reached, and it follows that specific views expressed in this Manual should not be ascribed to any particular persons involved in its drafting. [Part D] is different from other chapters in its conception, however. It represents an outline of particular country administrative practices as described in some detail by representatives from those countries, and it was not considered feasible or appropriate to seek a consensus on how such country practices were described. [Part D] should be read with that difference in mind."

In cases where countries provide updated versions of their country practices following publication of this edition of the Manual, they will be made available on the Tax Committee's website:

https://www.un.org/development/desa/financing/what-we-do/ECOSOC/tax-committee/tax-committee-home

1 Brazil—Country Practices[147]

1.1 Introduction: General Explanation

1.1.1 Brazil introduced a law on transfer pricing, through Law n. 9,430/1996, in 1996.[148] The bill was proposed to deal with tax evasion through transfer pricing schemes, and in line with this proposal it adopted the arm's length principle.

1.1.2 The methodology introduced by the law listed the traditional transaction methods (CPM and RPM) but denied the use of transactional profit methods (the PSM and TNMM) and formulary apportionment. Regarding the CUP Method, for exports or imports, the law introduced a methodology that is similar to OECD practices; and in addition Brazil also adopted the so-called Sixth Method (which is the CUP Method applied specifically for commodities). However, with regard to the CPM and RPM, instead of making use of comparable transactions, the law established fixed margins for gross profits and mark-up.

1.1.3 In 2012 the law was changed by adopting different margins for certain specific sectors as applicable to the RPM. The Brazilian perspective is that the conventional use of the RPM and the CPM implies some uncertainty and juridical instability, since they are implemented by the taxpayer without previous consent or summary review by the tax authorities. This affects stability and expectations in economic and fiscal relations.

1.1.4 Brazil's RPM and CPM with fixed margins are applicable to both export and import operations. In order to make them easier to understand

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148 Law n. 9,430/1996 was modified by Law 9,959/2000, Law n. 10,451/2002, Law n. 11,727/2008, Provisional Measure n. 499/2008, converted into Law n. 11,941/2009, Provisional Measure n. 478/2009, Provisional Measure n. 563/2012, converted into Law n. 12,715/2012, Provisional Measure n. 575/2012, converted into Law n. 12,766/2012 (this last one affecting only interest). These laws are consolidated and explained by administrative regulations issued by the Brazilian Federal Revenue Secretariat: Normative Instruction RFB n. 1,312/2012, available at http://normas.receita.fazenda.gov.br/sijut2consulta/link.action?idAto=39257&visao=anotado (text in Portuguese).

they are presented in the following paragraphs disregarding practical distinctions. A more detailed explanation to differentiate the application to imports and to exports and how to deal with that will be discussed separately. This is because the Brazilian transfer pricing law details the application of the two methods (RPM and CPM) for exports and imports in separate sets of rules. There are also specific methods for tradable commodities and interest that are addressed in paragraph 1.8.2 and following of this Chapter.

1.1.5 Brazil's RPM and CPM with fixed margins are not "safe harbour" methods. For these purposes, safe harbours mean provisions that apply to a defined category of taxpayers or transactions that relieve eligible taxpayers, at their own option, from certain obligations in pricing controlled transactions otherwise applicable under the arm's length standard. The RPM and CPM with fixed margins can be applied by the taxpayers as regular methods, not as safe harbours. The fixed margins are subject to modifications authorized by the Minister of Finance, based on the taxpayer´s request or *ex officio*, as discussed below.

1.2 Resale Price Method (RPM) with Fixed Margins

Explanation of the Methodology

1.2.1 The mechanism of the RPM using fixed gross profit margins is considered by Brazil to be similar to the conventional RPM with margins, except that the gross margins are set out in the rules, rather than being based on comparables (see Figure 1.1 below). In order to determine the transfer price (deemed arm´s length price, or parameter price, as it is called in Brazilian transfer pricing laws), the resale price that the reselling company (Associated Enterprise 2) charges to an unrelated customer (Independent Enterprise) is reduced by a fixed gross profit margin. The remainder is the acceptable transfer price between the associated parties (Associated Enterprise 1 and Associated Enterprise 2), which is the parameter price.

1.2.2 Reference is made below to two applications of how this method could be implemented for transfer pricing of products, including cases where the product is subject to manufacturing activities (value-added costs) before it is resold.

1.2.3 The method is based on the participation of transferred goods in the product that is resold (which is 100 per cent in a simple resale). Then the parameter price will be the resale price participation less a profit margin, fixed by law. Therefore, this methodology is also feasible to apply when other inputs (bought from independent companies) are combined with the inputs traded between associated enterprises and the final goods, manufactured from these different sources of inputs, are resold by a Brazilian enterprise.

1.2.4 Resale price (without manufacturing)

If the product traded between related parties is not subject to any manufacturing modifications the formula adopted will be the same and the participation ratio will be 100 per cent, since the price of Product A1 will be equal to the resale cost of Product A':

Figure 1.1
Resale Price Method (RPM) (without manufacturing)

Appropriate price? Price is given

(Net) Resale price	=	$ 10 000
Participation ratio (of Product A1 in Product A')	=	100%
Participation value (of Product A1 in Product A')	=	$ 10 000
Resale price margin (20%)	=	$ 2 000
Parameter price	=	$ 8 000

1.2.5 In this case the calculation is simple as the parameter price (deemed arm´s length price) is the resale price of the same product (charged between independent parties) reduced by: unconditional discounts granted; taxes and contributions on sales; commissions and brokerage fees paid; and a fixed profit margin of, for example, 20 per cent (according to current Brazilian law as at September 2016).

TP (parameter price) = NRP — GPM x NRP,

Where:

- TP (parameter price) = transfer price determined by Brazilian law. The maximum price on imports or the minimum price on exports;
- NRP = net resale price;
- GPM = gross profit margin = the value of gross profit margin ratio, as determined by law or tax regulations (20% in this simplified example); and
- TP (parameter price) = NRP—GPM x NRP = NRP—20% x NRP = 80% NRP.

Hence:

➢	(Net) Resale price	$ 10 000
➢	– Resale price margin (20%)	$ 2 000
➢	= A1 Transfer price under Brazilian law =	$ 8 000

1.2.6 Resale price (with manufacturing operation)

In this methodology the transfer price would be calculated having regard to the proportional participation of the goods negotiated between associated parties (Product A + input) in the goods resold to an independent enterprise (Product B). This methodology reduces the weakness of using the RPM when the reseller adds substantial costs to the product traded between associated parties. The resale price to be considered shall be that price agreed upon by the reselling company with an independent enterprise. More details are given below.

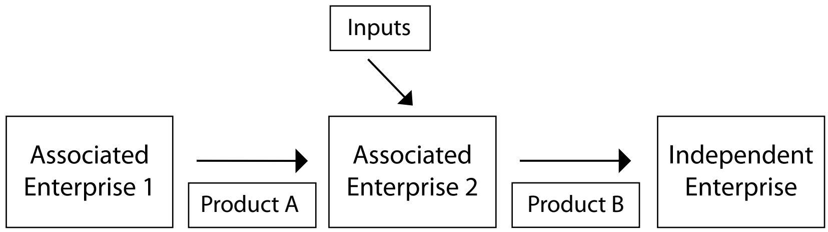
1.2.7 In this more elaborate approach the parameter price (deemed to be the arm´s length price) would be the difference between the *participation value* of the sale price of goods (Product A) in the net resale price (Product B) less its "*gross profit margin*" participation. For this purpose, the *participation value* of Product A in the net resale price (Product B) would be: the application of the *participation ratio* of the input (Product A) to the total cost of Product B multiplied by the *net resale price* (of Product B).[149]

1.2.8 The above-mentioned *participation ratio* is determined as follows: the ratio of the price of Product A (input) to the total cost of the goods resold (Product B), calculated according to the company's cost spreadsheet. The *net resale price* is the weighted average price of sales of the goods resold (Product B), less unconditional discounts granted, indirect taxes on sales, and commissions and brokerage fees paid. "Unconditional discounts" are those that do not depend on future events and that are detailed in the invoice.

1.2.9 The *gross profit* of Product A (in the resale of Product B) is the application of, for example, a 30 per cent (gross profit margin) on the *participation value* referred to above. As mentioned before, in this approach the gross profit margin will be provided by law. See Figure 1.1. The 30 per cent margin may vary depending on the economic sector of the activity performed by Associated Enterprise 2.

[149] It should be noted that the participation ratio has nothing to do with the fixed margin but depends on the cost of imported inputs and the COGS, see 1.2.8.

Figure 1.2
Resale Price Method (RPM) (with manufacturing)



Appropriate price? Price is given

(Where Product A is an input for Product B)

(Net) Resale price	=	$ 10 000
Participation ratio (of Product A in Product B)	=	60%
Participation value (of Product A in Product B)	=	$ 6 000
– Resale price margin (30%)	=	$ 1 800
Parameter price	=	$ 4 200

1.2.10 In order to avoid distortions between companies operating within Brazil it is necessary to ensure accounting uniformity between taxpayers in the country. If certain expenses are characterized as operating expenses by some companies and costs of goods sold by others the system will not be satisfactorily implemented.

The general formula for the inter-company transfer price would be (for a 30 per cent margin):

TP (parameter price) = PV—GPMV,

Where:

- TP (parameter price) = deemed arm's length transfer price determined under Brazilian law. The maximum price on imports or the minimum price on exports;
- PV = participation value of the goods transferred to the associated enterprise in the net resale price = (price of Product A ÷ total cost of Product B) x (net resale price of Product B);
- GPM = gross profit margin = the value of gross profit margin ratio, as determined by law or tax regulations (30% in this example);
- GPMV = GPM x PV = GPM x (price of Product A ÷ total cost of Product B) x (net resale price of Product B) = 30% (price of Product A ÷ total cost of Product B) x (net resale price of Product B); and

- TP (parameter price) = PV—GPMV = ((price of Product A ÷ total cost of Product B) x (net resale price Product B))–30% x ((price of Product A ÷ total cost of Product B) x (net resale price Product B)) = PV (1—GPM).

Fixed Margins for the Resale Price Method (RPM)

1.2.11 Brazilian transfer pricing legislation establishes different margins for specific economic sectors regarding the RPM for imports as follows (including simple resale operations and manufacturing operations):

1. **40 per cent**, for the following sectors:
   - Pharmaceutical chemicals and pharmaceuticals;
   - Tobacco products;
   - Equipment and optical instruments, photographic and cinematographic;
   - Machinery, apparatus and equipment for use in dental, medical and hospital;
   - Petroleum, and natural gas (mining industry); and
   - Petroleum products (derived from oil refineries and the like);
2. **30 per cent** for the following sectors:
   - Chemicals (other than pharmaceutical chemicals and pharmaceuticals);
   - Glass and glass products;
   - Pulp, paper and paper products; and
   - Metallurgy;
3. **20 per cent** for the remaining sectors.

1.2.12 In order to apply such margins, the law also states that in the event that the company engages in activities described in more than one of the categories mentioned above (1-3), the margin that should be adopted to apply the RPM is the margin corresponding to the activity sector in which the imported goods are intended to be used. In the event of the same imported goods being sold and applied in the production of one or more products, or if the imported goods are subjected to different manufacturing processes in Brazil, the final price parameter is the weighted average of the values found by applying the RPM, according to their respective destinations.

1.2.13 For exports the applicable margins in the foreign country are: 15 per cent for wholesale and 30 per cent for retail sales.

1.2.14 The Minister of Finance, ex officio (that is, by his or her own volition), or by request, is authorized by law to modify these margins. A request for modification presented by a taxpayer must be fully justified, and supplied with the proper documentation as established in the law.

1.2.15 Example 1: Resale of Same Product

A manufacturing enterprise domiciled in Country X, MCO, sells Product A with no similar product available worldwide to an exclusive distributor domiciled in Brazil, YD, for $16,000 per unit. YD, in its turn, resells the same Product A to customers for $18,750. According to the transfer pricing rules of Brazil, the RPM provides for a 20 per cent gross profit margin ($3,750). Therefore, the arm's length transfer price applicable to the transaction between MCO and YD would be $15,000 on imports of Product A. Thus for YD, the buyer, there will be a transfer pricing adjustment of $1,000 per unit ($16,000 – $15,000).

1.2.16 Example 2: Different Products, with Manufacturing Operation

A controlling enterprise domiciled in Country A, HOLDCO, sells inputs to a subsidiary domiciled in Brazil (a chemical plant other than pharmaceutical) for $400 per unit. In its turn, the subsidiary manufactures final products that are to be sold to local customers at $1,200 per unit (net resale price). Along with the inputs acquired from HOLDCO, the subsidiary also uses other inputs, acquired in the host country, in the industrialization process of the final product. The cost of such additional inputs corresponds to 60 per cent of the total cost of the final product, and so the participation ratio of the input sold by HOLDCO is 40 per cent ($400), thus the total cost is $1,000. The RPM in Country B imposes a fixed margin of 30 per cent in order to calculate the applicable transfer price. Based on the information above, the calculation is as follows:

- ➢ PV = participation value of the goods transferred to the associated enterprise in the net resale price = (price of Product A ÷ total cost of Product B) x (net resale price of Product B) = $400/$1000 x $1200 = $480;
- ➢ GPM = 30% in this example;
- ➢ GPMV = GPM x PV = $480 x 30% = $144;
- ➢ Thus, the parameter price (deemed to be the arm′s length price) = PV—GMPV = $480–$144 = $336; and
- ➢ As a consequence, the subsidiary should pay for imported inputs sold by HOLDCO up to $336 per unit in order to comply with transfer pricing rules. Thus there would be and adjustment per unit of $64 per unit ($400–$336).

1.2.17 **Example 3: Intercompany Software Licenses**

SIRFRO, a service provider domiciled in Country A, in Europe, exports licenses of unique software to its affiliated company established in Brazil, named SARPRO. Each software license agreement grants the affiliated company the right to sublicense it within their respective territory. As a result, SIRFRO charges SARPRO a monthly royalty fee of $140,000, while it makes $160,000 out of sublicense agreements per month. According to the transfer pricing rules of Brazil, the parameter price (deemed to be the arm´s length price) in transactions like the one performed by SIRFRO shall be calculated by decreasing a 20 per cent fixed gross margin of the sublicense price resold. Thus the parameter price would be equal to $160,000 minus $160,000 x 20%, which is $128,000. Thus the transfer pricing adjustment would be $12,000 per month ($140,000 – 128,000) to SARPRO´s tax basis, in Brazil.

Important note: This applies only to intangibles that are imported for resale; for other import operations with intangibles see 1.8.2.

1.3 Cost Plus Method (CPM) with Fixed Margins

1.3.1 Explanation of the methodology: Similar to the RPM with fixed margins, the CPM may be used with a predetermined gross profit mark-up. The basic functionality of this method is similar to the non-predetermined margin (or traditional) CPM except that the gross margins are set out in the rules rather than based on comparables. The method focuses on the related product manufacturing or service providing company determining transfer pricing for transactions with associated enterprises. As explained above, the parameter price (deemed to be the arm´s length price) is reached by adding a predetermined cost plus mark-up to the cost of the product or service. This will be a maximum value on imports or a minimum value on exports.

1.3.2 Unlike the RPM, the CPM with predetermined fixed gross profit mark-ups does not require the taxpayer to calculate the ratio of certain inputs to the final product. Thus, the gross profit mark-up is applied to the costs as a whole to determine the parameter price. See Figure 1.3 below.

The calculation formula is:

TP (parameter price, which is deemed to be the arm´s length price) = PC + GPM x PC = PC x (1 + GPM)

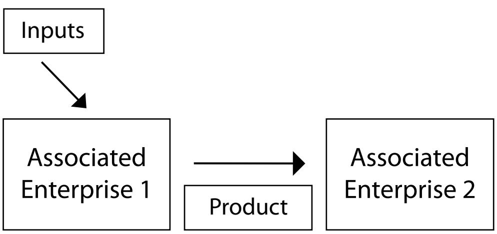
Where:

- TP (parameter price) = transfer price determined by Brazilian law. The maximum price on imports or the minimum price on exports;

- PC = product cost; and
- GPM = gross profit mark-up, as determined by law or tax regulations (20% in this simplified example, which is the fixed gross profit mark-up for export operations according to Brazilian law).

This method may also be applied in cases where the product is not subject to substantial modification, that is, where Associated Enterprise 1 merely resells the product to Associated Enterprise 2. This method can also be used for services and intangibles; however, the existence of cost sharing agreements in the latter case will make it more complex to apply.

Figure 1.3
Cost Plus Method (CPM)



Appropriate price?

Costs for Associated Enterprise 1	=	$ 5 000
+ Gross profit mark-up (20%)	=	$ 1 000
Parameter price (arm's length)	=	$ 6 000

Fixed Margins for the Cost Plus Method (CPM)

1.3.3 Brazilian transfer pricing law provides two fixed gross profit mark-ups for the CPM, depending on whether import or export operations are being addressed. For export operations from Brazil the fixed gross profit mark-up is 15 per cent, and for imports it is 20 per cent (which is the required gross profit mark-up for the export country).

1.3.4 The Minister of Finance, ex officio, or by request, is authorized by law to modify these margins. A request presented by a taxpayer must be fully justified, and supplied with the proper documentation as established in the law.

1.3.5 Example: Intercompany Distribution

PHARMAX, a pharmaceutical industry with headquarters in Brazil, acquires the active ingredient of a drug produced in its laboratories from an independent enterprise (located in Brazil or abroad). The price paid in the acquisition of the active ingredient is $100 per unit, while PHARMAX exports medicine to companies in the same MNE group for $120 per unit. The CPM in Brazil requires the exporter to stipulate prices taking into consideration a 15 per cent gross profit mark-up so as to comply with transfer pricing rules. As a result, from Brazil's perspective, PHARMAX should not sell medicine to its affiliates in the other countries for less than $115 per unit ($100 + 15% of $100). Thus there would be no transfer pricing adjustment ($120 > $115).

1.3.6 Example: Cost Plus Method (CPM) as Applied to Imports

PHARMCO is an MNE in the pharmaceutical industry with a distributor in Brazil named BRAZDIST. BRAZDIST imports a medicine produced by PHARMCO in Country B. PHARMCO acquires the active ingredient of this medicine from an independent enterprise, and incurs other operational costs that correspond to an amount (COGS) of $100 per unit. The price paid by BRAZDIST when importing such medicine from PHARMCO is $150 per unit. The CPM, in such cases, requires a 20 per cent gross profit mark-up so as to comply with transfer pricing rules. As a result, from Brazil's perspective, PHARMCO should not sell medicine to its affiliates in Brazil for more than $120 per unit ($100 + 20% of $100). Thus there would be a transfer pricing adjustment of $30 per unit applicable to BRAZDIST.

1.4 Differences Between the Application of the Methods Regarding Import and Export Operations

1.4.1 The RPM and CPM methods with fixed margins are applicable both to export and import operations.[150] Considering the RPM with fixed margins, depicted in Figures 1.1 and 1.2 of this Chapter, it would be applicable in the country of Enterprise 1 for export operations, and in the country of Enterprise 2 for import operations, hence:

[150] The Law and administrative regulations (named Normative Instructions) deal separately with import and export operations, considering particular aspects of each type, and also allowing for specific adjustments.

- For exports: TP (parameter price) > PV–GPM, which means that (PV–GPM) is the minimum acceptable transfer price for the tax basis calculation; and
- For imports: TP (parameter price) < PV–GPM, which means that (PV–GPM) is the maximum acceptable transfer price for the tax basis calculation.

1.4.2 Considering the CPM with fixed margins, in Figure 1.3 of this section, it would be applicable in the country of Enterprise 1 for export operations, and in the country of Enterprise 2 for import operations, hence:

- For exports: TP (parameter price) > PC (1 + GPM), which means that PC (1 + GPM) is the minimum acceptable transfer price for tax basis calculation; and
- For imports: TP (parameter price) < PC (1 + GPM), which means that PC (1 + GPM) is the maximum acceptable transfer price for tax basis calculation.

However, due to information accessibility the RPM is usually more suitable when the Brazilian company imports and the CPM is usually more suitable when the Brazilian company exports, as explained below.

1.5 Imports

1.5.1 Considering the case where the product resold is subject to value-added costs or manufacturing by the reselling associated enterprise, the RPM is normally more useful for imports than for exports. The reason for this is that companies may not disclose their production or manufacturing costs, even to other associated companies located in Brazil. This aspect would jeopardize the method's applicability for exports, because the necessary manufacturing cost data incurred by the associated importing enterprise would be unavailable for the associated Brazilian exporting enterprise and the Brazilian tax administration. Even if the enterprises involved have complete access to each other's books there is still the problem of information availability to the Brazilian tax administration. In addition, the transfer pricing regulations allow the use of a comparable by applying necessary adjustments.

1.5.2 If the RPM is applied for import transfer pricing, the manufacturing importer uses its own accounting book costs to calculate the correct transfer price, with no need to request the cost data incurred by the exporting associated enterprise. Furthermore, in the case of imports the tax administration has full access to evaluate the uncontrolled operations (with independent enterprises). As a result, the RPM with fixed margins is recommended for import operations.

1.6 Exports

1.6.1 For the corresponding reasons mentioned above as regards the RPM, the CPM is more practical for exports than for imports. Companies may not disclose their production or manufacturing costs, even to other associated companies located in Brazil, which jeopardizes the method's applicability for imports, because the necessary manufacturing cost data incurred by the associated exporting enterprise may be unavailable for the associated Brazilian importing enterprise. Even if the enterprises involved have complete access to each other's books there is still a problem of information accessibility to the Brazilian tax administration.

1.6.2 If the CPM is applied for determining the export transfer price the Brazilian manufacturing exporter uses its own booked costs to calculate the correct transfer price, with no need to request any data from the non-Brazilian affiliate. Furthermore, in the case of exports, all necessary information can be accessed and verified by the Brazilian tax administration. As a result, the CPM with fixed margins is typically applied for Brazilian export operations.

1.7 Strengths and Weakness of the Brazilian Methods with Predetermined Profit Margins

1.7.1 The strengths of Brazil's predetermined profit margins when using the RPM and CPM, which focus on simplicity, include:

- Avoiding the need for specific comparables;
- The use of the conventional RPM and CPM depends on the availability of certain data, databases or reports to empirically determine the gross profit margin and gross profit mark-up. In general, these elements are not easy to find;
- Freeing scarce human resources and being able to be applied without technical knowledge of specific transfer pricing issues;
- Stabilizing the expectations of taxpayers with respect to their Brazilian tax liability associated with inter-company transactions;
- Providing a low-cost system for companies and the tax administration by doing away with one aspect of a transfer pricing analysis, the need to empirically determine gross margins;
- Including a strong emphasis on practicality;
- Not distorting competition among enterprises located where the methodology is applied, since they are subject to the same

tax burden, and they are not benefitting from asymmetry of information;

- Allowing for simple implementation by tax authorities when auditing taxpayers; and
- Simplicity of application for taxpayers.

1.7.2 The weaknesses of Brazil's predetermined profit margins when using the RPM and Cost Plus Method include:

- The approach may lead to double taxation if there is no access to competent authorities to negotiate relief from double taxation;
- These methods require clear classifications and accounting conformity with respect to the allocation of expenses between COGS and operating expenses; and
- It is unavoidable that some Brazilian enterprises will be taxed at (higher or lower) profit margins not compatible with their profitability. This is because the fixed margin method applies regardless of the cost structures of taxpayers. For example, otherwise economically identical taxpayers with large COGS relative to operating costs will face higher tax burdens than taxpayers with low COGS relative to operating costs.

1.8 Other Explanations of the Brazilian Transfer Pricing Methodology

1.8.1 The law and regulations set a precise number of methods for import and export transactions that are, in fact, specific methodologies for CUP, CPM and RPM, as follows:

- **For import transactions:**
  - Comparable Uncontrolled Price (CUP) (PIC and PCI used for transactions in commodities) (equivalent to CUP Method);
  - Resale Price Method (RPM) (generally 20% gross profit margin (PRL) (equivalent to RPM) + other margins for specific sectors (see above section 1.2.11); or
  - Cost Plus Method (CPM) (20% mark-up margin) (CPL) (equivalent to CPM).
- **For export transactions:**
  - Comparable Uncontrolled Price (CUP) (PVEx and PECEX used for transactions in commodities) (equivalent to CUP Methods);
  - Wholesale Price in the Country of Destination Less Profit

Method (15% margin) (PVA) (equivalent to RPM);

- Retail Price in the Country of Destination Less Profit Method (30% margin) (PVV) (equivalent to RPM); or
- Cost Plus Method (CPM) (15% profit margin) (CAP) (equivalent to CPM).

1.8.2 In the case of the import or export of commodities subject to trading in internationally recognized mercantile and futures exchanges the method that should be used for imports is the Imports with Price under Quotation (PCI) Method, which is a simplified version of the CUP Method for imports, as defined in the law, and for exports is the Export with Price under Quotation (PECEX) Method, which is a simplified version of the CUP Method for exports, as defined in the law. This mandatory methodology for such products considers the average quotation price on the global market as the arm's length price. The law has established that the price to be considered is the average daily price of goods or rights subject to public prices in commodities futures on internationally recognized exchange markets (quoted price). However, the law allows for adjustment of the price for the market premium at the date of the transaction, and other adjustments such as quality of goods traded and terms of payment. If there is no transaction in the organized market on a specific date the price to be taken into consideration is the last price information available in the market. If no price is available at all the taxpayer and tax authority may consider an internationally recognized database as a means of establishing a price. This approach for commodities is in line with the updated version of the OECD Transfer Pricing Guidelines after BEPS.[151]

1.8.3 Brazilian transfer pricing legislation does not apply to payments of royalties and technical, scientific, administrative assistance or similar activities (on imports), which remain subject to the conditions for deductibility set out in the tax legislation. In this regard the transfer pricing legislation applies, in general, only on export operations, and, in a limited way, on intangibles that are imported for resale (see Example 1.2.17 above).

1.8.4 Under Brazilian transfer pricing legislation there are special rules for interest (paid or credited), which are similar to the fixed margin approach if one considers the issue of predictability and clarity. Current legislation states

[151] The BEPS Report on Actions 8-10 added paragraphs to Chapter II of the Transfer Pricing Guidelines, immediately following paragraph 2.16 on this issue. For additional details see Valadao, M.A.P (2016). Transfer Pricing in Brazil and Actions 8, 9, 10 and 13 of the OECD Base Erosion and Profit Shifting Initiative. *Bulletin for International Taxation*, pp. 296–308..

that in the case of a controlled loan transaction (between related parties), or similar transaction, the interest rate to be applied to the transaction is:

(i) In the case of transactions in US dollars with a prefixed rate: market rate of the sovereign bonds of the Federal Republic of Brazil issued in the foreign market in US dollars;

(ii) In the case of transactions in Brazilian reals with a prefixed rate: market rate of the sovereign bonds of the Federal Republic of Brazil issued in the foreign market in reals; and

(iii) In all other cases, the LIBOR rate for 6-month deposits;

plus a spread as determined by a tax administrative rule issued by the Minister of Finance. If the actual interest rate of the transaction is different, it is subject to adjustment accordingly. With respect to interest expenses, the spread to be added to the interest rates as mentioned above is 3.5 per cent; with respect to interest credited (received from abroad), the spread to be added to the interest rates as mentioned above is 2.5 per cent.

1.8.5 The interest rate calculated in accordance with these rules is deemed to be the arm's length rate. The rules also apply to transactions between a resident company and a resident in a non-cooperative/low-tax jurisdiction as defined by the law, regardless of whether the resident abroad is a related party.

1.8.6 The Brazilian transfer pricing regulations establish that if the taxpayer finds a deviation of 5 per cent, or less, between the actual transfer price and parameter price calculated in accordance with the Brazilian transfer pricing legislation, the taxpayer is not requested to make any adjustment. Thus, in practice there is a range for each price. This allowance rate is only 3 per cent when the method is the CUP for commodities (the so-called 6th method, which corresponds to PCI, for imports, and PECEX, for imports, in Brazilian nomenclature).

1.8.7 Brazilian transfer pricing legislation also establishes a broad definition of related parties, which is intended to counter tax planning schemes (as a specific anti-avoidance rule), and this also affects transactions between individuals and companies and some specific transactions (back to back transactions, interposed persons). The transfer pricing legislation also applies to all transactions with Brazilian residents and residents in low-tax jurisdictions, as defined in the law, regardless of whether the persons and companies performing the transaction are related. Brazil adopts a list of jurisdictions as prescribed by law and detailed through administrative regulations that encompass low-tax jurisdictions, non-cooperative jurisdictions and also privileged tax regimes.

1.9 Comments for Countries Considering the Adoption of Fixed Margins

1.9.1 Countries may establish different profit margins per economic sector, line of business or even more specifically according to the kind of goods or services dealt with, to calculate the parameter price (deemed arm's length price). The more accurately these are computed and the more margins are established, the more likely it is that the use of the margins will neither distort the system nor the decisions of the players involved.

1.9.2 It may not be possible to justify establishing many different margins, depending on the actual amount and types of goods and services exported and imported by a country. This is because it is possible that the country does not export or import a sufficiently large amount or many types of those goods and services and the determination of such margins, or even their applicability, could lead to some difficulties.

1.9.3 If a country opts for the application of different margins these may be established at different levels of specificity. In other words, such margins could be determined by the economic sector (e.g. the primary sector, i.e. the extraction or production of raw materials; secondary sectors such as manufacturing; and tertiary sectors such as services). A country may differentiate further, so that the margins could be determined by line of business at different levels of specificity according to the necessity and ability of a country to determine them. For example, the country could use a margin for the chemical industry as a whole, or different margins for different types of products of the chemical industry (agrochemical, petrochemical, explosives, cosmetics etc.). The possibilities are nearly limitless. The differentiation per industry into types of products is adopted by Brazil, where, for the RPM for imports, the margin for the chemicals sector in general is 30 per cent, while the margin for pharmaceutical chemicals and pharmaceuticals is 40 per cent. See paragraph 1.1.3. above.

1.9.4 Each country should determine, according to its specific circumstances, the amounts involved and types of goods and services, how specific the margins should be and whether more margins are merited. Also a country may combine different levels of margin specifications if it seems appropriate; it may set forth some general margins for a line of business in addition to more specific margins for some goods.

1.9.5 In order to determine such fixed margins, the tax authorities will need to do pricing research or purchase such information from existing (public) databases, in order to find appropriate prices that could be used as a comparable. Then, if it seems necessary to specify more profit margins, the tax authorities will need to determine a range of profit margins, that is, a maximum and a minimum profit margin that statistically corresponds to relevant data from uncontrolled transactions. The maximum and minimum profit margins simply represent an acceptable margin of divergence.

1.9.6 It is recommended that relevant taxpayers or groups that represent them verify the research, and that the margin found for each sector, line of business, product or service could be applicable to any or the vast majority of transactions in that situation. In short, this method suggests that a margin that is used for a sector, line of business or specific goods and services can be used for similar situations in the same business sector.

1.9.7 It is important to emphasize that what will be applied, in practical terms, are not "margins" but "ranges". As a result, what will be identified for a specific sector is an average. Thus, some companies may understand that they will fall below the average number, while others will fall above that number. For example, it is assumed that based on market research in a specific country the average market gross profit for resale transactions in the pharmaceutical sector is 30 per cent. It may well be established that some companies have a 25 per cent margin and others a 38 per cent margin. Thus it would be advisable to have a range—in this case say 28 per cent to 35 per cent—that is regarded as acceptable. The exact calculation of the range will depend on the distribution of the margins; in any case, the fixed margin should be inside the range. The details depend on the market, and if the range is very wide, that in itself indicates the need for further specification to a line of products, or even to a specific product.

2 China—Country Practices[152]

Transfer Pricing Opportunities and Challenges for Developing Countries in the Post-BEPS Era

2.1 Introduction

2.1.1 On 5 October 2015, the Organization of Economic Cooperation and Development (OECD) published 15 final reports and an explanatory statement on the Base Erosion and Profit Shifting (BEPS) project. After an intensive two-year process, the international tax reform mandated by the G20 leaders and coordinated by the OECD has finally come to fruition. The post-BEPS era focusing on the implementation of the BEPS outcomes was ushered in. One thing that made this reform different from the previous ones is the involvement of many developing countries in both the early stage when the various measures were developed and the later implementation phase. Voice of the developing countries has started to be heard by the global community when international tax policies were made. This unprecedented event has provided the developing countries with an opportunity to begin at the same starting line as their developed counterparts. However, the opportunity comes with challenges. Having the right to speak does not necessarily mean being ready to speak. Getting involved is far from being able to lead. After all, it is imperative that the developing countries continue to build capacity in tax administration to get more ready to speak and lead.

2.1.2 As a G20 member, the world's major economy and the largest developing country, China has been actively involved with the BEPS project since 2013. The State Taxation Administration ("STA") has endeavored to attend every relevant BEPS meeting, trace the progress of the project, research on many topics such as intangibles for transfer pricing purposes and comparability analysis. In the process, the STA has provided China's position on various issues like location specific advantages ("LSAs"), exploitation of

[152] Contributed by the State Taxation Administration of People's Republic of China.

intangibles, and application of PSM. During the post-BEPS phase, China values the outcomes of BEPS project and has adopted some of them into domestic legislations. China welcomes OECD's effort to build the Inclusive Framework by inviting more jurisdictions especially the developing countries to commit to the follow-up work including further research on specific areas as well as implementation accompanied by review and monitoring. This will lead to enhanced coordination and cooperation across the globe. On the other hand, China calls for more respect to jurisdictions' sovereignty during the review and monitoring process. Given the nature of developing countries, more flexibility is also essential for them to play on the level field with developed countries. A fair and equitable international tax system that benefits all the participants can only be built if the jurisdictions remain autonomous and informed even though they are subject to review. As the G20 leaders' communiqué at Hangzhou summit pointed out, all the members "will continue the support for international tax cooperation to achieve a globally fair and modern international tax system and to foster growth".

2.1.3 Transfer pricing is a weighty component of the international tax reform as 10 of the 15 action plans relate to it. The BEPS project was set to tackle the epidemic situation where profits had been left untaxed because multinational enterprises ("MNEs") had managed to shift the income to no-tax or low-tax jurisdictions. Historically, transfer pricing administration had been focusing on dealing with how to allocate taxing rights between jurisdictions and preventing/eliminating double taxation under mutual agreement procedures ("MAP"). The priority of the ongoing international tax reform, however, was to address double non-taxation where MNEs paid no taxes or less than their fair share of taxes in jurisdictions with well-established corporate income tax regimes. The support shown by more than 100 countries and regions for the BEPS project suggests that this common goal was able to rally interested tax jurisdictions including both developed and developing countries to work together. Yet some important questions remain unanswered. For example, has the project resolved all the differences developed and developing countries have in transfer pricing? Or, have the international tax rules become fairer and less biased as the result of the reform? Thanks to the concerted efforts by developed and developing countries in combating tax avoidance, the reform now needs to reconsider the classic transfer pricing question of how to allocate profits retrieved from the tax havens. The rules need to be fair and clear on who creates value and how the profits should be allocated between countries. The overarching principle of the BEPS project that the profits should be taxed where economic activities occur and value is created has guided jurisdictions to develop measures to counter tax avoidance in tax havens. That being said, developing countries need more specific rules and practical guidance on important issues such as how to determine the places of economic activities and value creation, how to allocate the profits retrieved from the tax havens between countries with corporate income tax system, how to divide the pie between countries both of which are the places of economic activities and value creation, and above all, how to apply arm's length principle in transfer pricing legislation and practice. This is where this United Nations Practical Manual on Transfer Pricing for Developing Countries comes in handy.

2.1.4 Amongst the 15 Action Items of the BEPS Project, Action 1 drew a lot of attention. However, the 2015 Final Report failed to deliver a solution to the broader tax challenges raised by the digitalization of economy. Since then, member states of the Inclusive Framework, including China, have been working together towards reaching a consensus-based solution. As the solution is still under development, how it will interact with the existing international tax rules, and how it will affect the post-BEPS international tax landscape shaped by the other 14 Action Items is remained to be seen. Nonetheless, developing countries need to be prepared for the new challenges and opportunities that this change will bring about, including in the area of transfer pricing.

2. 2 Part One: Recent Developments in China Transfer Pricing Practice

2.2.1 The transfer pricing tax regime was first introduced in China in 1991. Over the past 3decades, the Chinese tax administration has been exploring ways to improve the transfer pricing administration and have made significant improvements over the last 10 years. Drawing from practical experience and international best practices, the Chinese tax administration was able to establish a well-rounded transfer pricing tax regime that includes legal framework, practical guidance, administrative process and operational mechanism. Dedicated transfer pricing teams were also trained and deployed at various levels of tax offices. With the view to stopping profit shifting and protecting China's taxing right, the Chinese tax administration also recognizes that it is important to respect facts and data in any transfer pricing analysis.

2.2.2 Transfer pricing administration has been put at the centre of STA's anti-avoidance work agenda in the recent years. Recognizing that preventative measures are as important as transfer pricing audits, the STA has built a three-pronged tax avoidance prevention and control system with consistent and standardized approach for administration, service and investigation. It is important that tax avoidance prevention should run parallel to transfer pricing investigations. Ways to prevent taxpayers from evading tax obligation include strengthened tax administration and improved taxpayer service. Investigations are only used as deterrence to foster taxpayer voluntary compliance. Moreover, different measures were taken to build a three-pronged tax avoidance prevention and control system. The first aspect of the three-pronged system is administration. A tracking system was put in place to monitor the profits of foreign MNEs operating in China. Chinese tax administration has put extra emphasis on routine review of related party filings and contemporaneous transfer pricing documentation. Follow-up monitoring subsequent to transfer pricing audits was implemented to encourage taxpayers to ensure their profitability is in line with the arm's length principle. As to the second prong, service, seminars and trainings were provided to inform taxpayers of the latest tax regulations and policies. Double taxation was prevented (eliminated) through unilateral/bilateral APAs and resolution of MAP cases. With regard to the last aspect, investigation, both isolated and coordinated anti-avoidance audits were carried out to act as deterrence to regulate the profitability of individual companies or particular industries. Above all, the tax offices across the country have coordinated their actions to ensure that both domestic laws and international policies were followed in a consistent and standardized manner. As a result, inconsistency due to different work procedures was reduced to the minimal. The developments in China's transfer pricing administration can be therefore summarized in the following 8 aspects.

2.3 Domestic Legislation and Practical Guidance

2.3.1 Legislation always comes first in transfer pricing. The Tax Collection and Administration Law and its Implementation Regulations and the Enterprise Income Tax Law and its Implementation Regulations and Individual Income Tax Law all contain clauses on transfer pricing. The first time that China introduced a comprehensive anti-avoidance regime into the legislation was through the "Special Tax Adjustment" provision in Chapter 6 of the Enterprise Income Tax Law and its Implementation Regulations in 2008. Not only did this chapter include provisions on transfer pricing and APA with which China had more experience but also clauses on cost sharing agreement, thin capitalization, control foreign companies, general anti-avoidance rule and the levy of interest as a result of transfer pricing adjustments for which China had to draw on international experience. In January 2009, the STA released the Implementation Measures of Special Tax Adjustments (Trial Version) (more commonly known as the "Circular 2"). It had since served as the practical guidance for China's transfer pricing, and in broader scope, the anti-avoidance administration. and provided the legal basis for tax administration's assessments and taxpayer compliance.

In August 2018, transfer pricing rules, controlled foreign corporations rules, and general anti-avoidance rules were introduced into the newly revised Individual Income Tax law. Starting from 2016, STA has released a series of regulations to revise and update the Circular 2. Firstly, the Public Notice on Matters Regarding Refining the Filing of Related Party Transactions and Administration of Contemporaneous Transfer Pricing Documentation (Public Notice of the STA [2016] 42, hereafter referred to as the "Public Notice No. 42") was put into effect in June 2016. As set out in the BEPS Action 13, Public Notice No. 42 has adopted clauses to require qualified taxpayers to file Country-by-Country reports in China. Public Notice on Matters Regarding Enhancing the Administration of Advance Pricing Arrangements (Public Notice of the State Administration of Taxation [2016] 64, hereafter referred to as "Public Notice No. 64") was then released to provide more detailed guidance on the APA process. The release of Public Notice of the State Administration of Taxation on Issuing the "Administrative Measures of Special Tax Investigation and Adjustment and Mutual Agreement Procedure" (Public Notice of the State Administration of Taxation [2017] 6, hereafter referred to as the "Public Notice No. 6") replaced the procedural guidance relating to transfer pricing as set out in the Circular 2.

2.4 Centralized Approval System to Assure Consistency and Standardization

2.4.1 There are more than 720,000 tax officials and 36 provincial level tax offices in China. It is paramount for a big country like China to be consistent and standardized in law enforcement especially when it comes to transfer pricing administration. A MNE might set up 30 subsidiaries across China. Without a consistent standard, tax administrations from different areas may find disparate comparable sets and derive various profit levels for transfer pricing cases of similar nature. To prevent this from happening, the STA has put in place a national anti-avoidance system under which tax administrations are to report and obtain approval from the STA headquarters when they need to initiate or close an anti-avoidance (including transfer pricing) case since 2015. The reporting chain put in place to standardize the audit procedures, improve the quality of closed cases, strengthen audit efforts, and organize national coordinated investigation. In 2012, the STA released the "Internal Approval Procedures for Substantial Special Tax Adjustment Cases (Trial Version) (Guoshuifa [2012]16) (hereafter referred to as the "Internal Approval Procedures") to streamline procedures including related party filing review, contemporaneous transfer pricing documentation analysis, high-risk taxpayer identification, case initiation, audit and analysis, case closing, and follow-up taxpayer monitoring and tracking subsequent to an audit. As required by the "Internal Approval Procedures, a three-level transfer pricing audit system was established. The system features collective decision and penal approval. First, for every audit case, the in-charge tax administration needs to set up special task team to conduct the investigation. Second, the task team needs to formulate the preliminary assessment and report it to the tax administration at provincial level whose specialist panel is responsible for approving the case. In addition, for a case qualified as a substantial case especially a case that requires national coordination, the STA headquarters needs to call upon a nation-wide expert panel to make the final decision on the case. In September 2016, the STA has released the Internal Procedures for Special Tax Adjustment (Shuizongfa [2016]137), in which the roles and responsibilities of tax administrations at different levels and the collective review and approval system were further clarified. This system has enabled the tax administrations of different areas to work in a manner that would ensure the consistency in the selection of transfer pricing method and the determination of appropriate profit levels. A unified work standard across the country was formed accordingly. The consistency has made tax assessments more effective as deterrence measures. Tax officials are better protected from risks in enforcing the law thanks to the internal control system built according to the "Internal Procedures for Special Tax Adjustment".

2.5 Monitor Profits of MNEs in China

2.5.1 Transfer pricing administration needs to move up the line of defense. Prevention can be very effective in fostering taxpayer voluntary compliance with the arm's length principle and fulfilling tax obligation. Only when the taxpayers fail to be compliant the audits should be initiated. To better leverage the preventive effect, the STA has installed a monitoring system to track the profits of MNEs in China. The primary data sources are the annual corporate income tax returns and the accompanying related party filings. The information is compiled, compared and analyzed by year, industry, and geographical area. A monitoring system was designed to combine industry analysis with individual taxpayer screening. Tax administrations would receive alerts when the risks are identified. The history record and performance evaluation that the tax authorities have with a particular taxpayer can also be accessed in the system. In addition, by requiring taxpayers to prepare contemporaneous transfer pricing documentation and monitoring taxpayers in the follow-up years subsequent to the audits, taxpayers can better understand tax administrations' approach to transfer pricing administration.

2.6 Intensify Audit Efforts

2.6.1 Audit efforts for nationally coordinated cases that involve several companies in a same industry or multiple subsidiaries of a same MNE group were intensified to improve the quality of closed cases. Investigations should be carried out in a consistent and standardized manner so that inconsistent assessment simply because tax administrations have different ways to go about cases that involve companies in the same industry or subsidiaries of a same group can be avoided. The transfer pricing audits can therefore be more effective as a tax avoidance deterrence measure. In the past years, China has initiated several nationally coordinated audits targeting industries including shoe manufacturing, computer manufacturing, high speed road construction, retail stores and hotels and fast moving consumer goods. Apart from being subject to the nationally coordinated audits, automobile sector, luxury goods industry and pharmaceutical companies were also being analyzed at the industry level. The "income approach" was developed and applied to multiple cases to address the challenges posed by transfer of equity and intangibles between related parties. The Chinese tax administration has attached great importance to several key industry sectors and been paying attention to possible base erosion transactions including outbound payments and transfer of equity. In the meantime, the use and transfer of intangibles, intragroup services, and financial transactions have gradually come to the fore of Chinese tax administration's work, which has contributed to the quantitative analysis of location specific advantage

2.6.2 The tax revenue contributed by the anti-avoidance work was RMB 679,000,000 in 2006 and RMB 64,634,000,000 in 2019. The number was more than 94 times higher with an annual increase rate of 41.97%. The revenue contribution from the administration measures was 56,872,000,000, whereas the revenue collected through the service measures was 2,719,000,000. And the rest was contributed by the audit adjustments.

2.7 APA Programme and MAP Process

2.7.1 China has in place a MAP mechanism to eliminate double taxation resulted from transfer pricing audits and a bilateral APA programme to provide early certainty for cross-border taxpayers. Unilateral APAs can also be reached between the Chinese tax administration and the taxpayers. By the end of 2019, China has signed 76 bilateral APAs and 113 MAP agreements with 15 countries. During the negotiations, where appropriate, concepts such as value chain analysis and factors contributing to value creation long held by the Chinese tax administration were discussed with and recognized by some treaty partners. In order to better inform the public of China's APA programme, the STA started to release "China APA Annual Report" in 2010. So far 10 reports have been published on the OECD official website and met with well reception from the international community.

2.8 Expand Data Sources for Comparability Analysis

2.8.1 Internal data extracted from corporate income tax returns and VAT refund database has played a primary role in identifying high-risk taxpayers. Meanwhile, external data obtained from National Bureau of Statistics, General Administration of Customs, State Administration of Foreign Exchange along with business information compiled in the National Database of Companies in Secondary Sector, Bureau van Dijk, Standard & Poor's Net Advantage was also put to good use in comparability analysis.

2.9 Enhance International Communication and Cooperation

2.9.1 The STA has actively participated in meetings organized by the UN and the OECD. The STA has also presented China's position on important issues including intangibles, transfer pricing documentation and comparability analysis and brought in concepts like exploitation of intangibles, quantification of location specific factors, value contribution by decision execution that were later incorporated into the updated OECD Transfer Pricing Guidelines. By taking opportunities to talk to tax officials from other countries as well as representatives from MNEs, the STA was able to foster mutual understanding with them. On top of that, the STA has always been willing to share China's experience in transfer pricing legislation and practice with other developing countries. Productive discussions on application of location savings and market premium in transfer pricing was generated in the process.

2.10 Build a Professional Transfer Pricing Team

2.10.1 Building a dedicated transfer pricing team has always been the priority of the STA. Trainings on anti-avoidance has been conducted in various forms such as discussions on domestic legislation, peer-to-peer case sharing, seminars delivered by experts from the OECD as well as from other countries, special training sessions on difficult topics such as transfer pricing involving intangibles, financial service sector, and pharmaceutical industry. The combination of in-class training and on-job learning has yielded good results as evidenced by significant improvement in tax officials' professional capabilities. On the other hand, resources have been devoted to transfer pricing administration as well. Tax bureaus specialized in anti-avoidance work were set up in Beijing, Jiangsu province and Shenzhen. The purpose was to pool the local talents and let them focus on transfer pricing and other anti-avoidance work. In addition, in response to the increased workload related to transfer pricing audits and bilateral negotiation in the post-BEPS era, the STA has enhanced efforts in the training and development of talents for transfer pricing to ensure that sufficient resources and manpower is allocated to the work.

2.11 Part Two: China's Transfer Pricing Regime

2.11.1 As provided by the Tax Collection and Administration Law, Enterprise Income Tax Law and the Individual Income Tax Law, the core of China's transfer pricing regime is the arm's length principle. Just like many countries in the world, China has made great efforts to uphold the arm's length principle despite many challenges encountered in the process. That being said, China's transfer pricing regime has drawn on some other internationally recognized norms besides the arm's length principle. Transfer pricing is essentially an issue of allocation of taxing rights among countries which could lead to audit adjustment that could result in double taxation for a MNE group. Both the country that initiates the audit and the country in which the related party is resident should ensure that the treaty obligations to prevent and eliminate double taxation are implemented. In order to resolve double taxation, the two countries need to negotiate with each other. The agreement can only be reached if both the negotiating parties are looking at the same principles, rules and methods. Therefore, it is necessary to have a set of international rules on transfer pricing that are respected by all countries.

2.11.2 However, the inherent disparity between countries cannot be overlooked. Countries may be subject to different domestic conditions or have unique tax regimes. Different stages of economic and social development might pose distinct challenges too. All these factors need to be taken into account when designing international rules. Both developed and developing countries can find the general rules to be fair and easier to accept if they reflect different needs and conditions of the countries. By the time this chapter is drafted, China has signed double taxation treaties with 108 countries and the number is only dwarfed by that of UK and France. In addition, China is the top destination for foreign investment in the meantime has the volume of outbound investment that is only second to the US. The extensive treaty network and ever-growing need for cross-border investment has prompted China to engage in bilateral treaty negotiation with many countries. The situation dictates China to follow international standards in dealing with transfer pricing or other international taxation issues. The fast economic and social development for the past 40 years has also made China one of a kind. The uniqueness shows in China's transfer pricing area as well. This is why China needs to strike a balance between conforming to international conventions while being able to deal with some unique issues for transfer pricing purposes.

2.12 Related Party Filing

2.12.1 Article 43 of the "Enterprise Income Tax Law" stipulates that taxpayers need to attach related party transaction report to their annual corporate income tax returns. Both resident and non-resident taxpayers required to file annual corporate income tax returns shall submit related-party filings. Public Notice No. 42 added some forms, including the forms for CbC reporting, to the original "Annual Reporting Forms for Related Party Transactions" and making them 19 altogether. Aside from filling the 6 forms for CbC reporting (3 in Chinese and 3 in English), companies should report related party transactions incurred by type (i.e., tangibles, intangibles, financial assets, intragroup financing, service provision, etc.). According to the Public Notice No. 42, Chinese Tax resident enterprises that fall into any of the following two categories shall file the CbC report: (1) The resident enterprise is the ultimate holding company of a MNE group having total consolidated group revenue of more than 5.5 billion RMB during the fiscal year immediately preceding the reporting fiscal year as reflected in its consolidated financial statements for such preceding fiscal year. (2) The resident enterprise has been appointed by the MNE group to file the CbC report. The introduction of CbC report filing obligation set out by Public Notice No. 42 was one of the measures taken by China to implement the 4 minimum standards of the BEPS project.

2.13 Related Party Relationships

2.13.1 The existence of related party relationships is the prerequisite for related party filing and the basis for tax administration's transfer pricing adjustments. Article 109 of the Implementation Regulations for the Enterprise Income Tax Law provides that the related party relationship refers to direct or indirect control relationship with respect to capital, business operation, purchases and sales. The definition was exemplified in Public Notice No. 42 which provides for 7 types of related party relationships. For example, 25% shareholding is the ownership threshold to constitute the related party relationship.

2.14 Contemporaneous Transfer Pricing Documentation Requirements

2.14.1 Chinese corporate taxpayers are required by the law to prepare contemporaneous transfer pricing documentation by tax year and submit it when requested by the tax administration. Contemporaneous transfer pricing documentation may include master file, local file and special issue file. Any enterprise that meets one of the following criteria shall prepare a master file : (1) The enterprise that has incurred cross-border related party transactions during the tax year concerned, and the MNE group to which the ultimate holding company which consolidates the enterprise belongs has prepared a master file. (2) The annual total amount of the enterprise's related party transactions exceeds RMB 1 billion. The master file is to provide an overview of the global business operations of the MNE group to which the ultimate holding company belongs. Different from the recommended legislation template set out in the BEPS Action 13 report, the master file submitted to Chinese tax administration also needs to include (1) A description of business restructurings, industrial restructurings, transfers of functions, risks or assets occurred within the group during the fiscal year; (2) functions, risks, assets and personnel of principle research and development facilities; (3) Name and location of the constituent entity that files the CbC report for the MNE group; and (4) a list of the MNE group's existing unilateral advance pricing agreements, bilateral APAs.

2.14.2 Any enterprise that meets one of the following criteria during the fiscal year shall prepare a local file: (1) The annual related party transfer of tangible asset exceeds RMB 200 million (for toll manufacturing transaction, the amount is calculated using the import/export customs declaration prices); (2) the annual related party transfer of financial assets exceeds RMB 100 million; (3) The annual related party transfer of intangibles exceeds RMB 100 million; (4) the annual total amount of other related party transactions exceeds RMB 40 million. In addition to what is required in the Action 13 report, taxpayers need to provide (1) value chain analysis that notes the measurement and attribution of value creation contributed by location specific factors; (2) information on outbound investment; (3) information on related party equity transfer; and (4) information on provision/receipt of related party service. Also, Public Notice No. 42 has set out detailed filing requirements for the description of business, related party, and related party transactions of local entities. Furthermore, taxpayers need to describe local entities' contribution to the group's overall profit or residual profit regardless of the transfer pricing method selected. Aside from the master file and local file, Chinese taxpayers need to prepare special issue file as part of their contemporaneous transfer pricing documentation if certain criteria are met. Special issue files include report on cost sharing agreements and thin capitalization. An enterprise that is a party toa cost sharing agreement shall prepare a special issue file. Similarly, an enterprise with a related party debt-to-equity ratio exceeding the prescribed threshold shall prepare a special issue file.

2.15 Transfer Pricing Audits

2.15.1 Chinese taxpayers whose transfer pricing of the related party transaction are inconsistent with the arm's length principle could be subject to audits conducted by the tax administration. The transfer pricing audit procedures are made very clear in the Public Notice No.6. It embodies the essence of the minimum standards required by the BEPS Action 14 (Making Dispute Resolution Mechanisms More Effective) and is the culmination of China's efforts to revise and update the Circular 2. Public Notice No.6 also reflects the outcomes of the BEPS Action 8-10 Final Report (Aligning Transfer Pricing Outcomes with Value Creation).

2.15.2 Through reviewing taxpayers' related party filings and contemporaneous transfer pricing documentation as well as tracking profitability of MNEs in China, the Chinese tax administration has been able to identify taxpayers with transfer pricing risks and alert the taxpayers to the risks. The taxpayers are allowed to make self-adjustment after recognizing the existence of the risks either as the result of the tax administration's alerts or an effective internal control system. To the extent that the adjusted results do not conform to the arm's length principle, the tax administration may initiate transfer pricing audits on the taxpayers.

2.15.3 Taxpayers fall into the following categories would be more likely to be identified as the potential transfer pricing audit targets during the screening process. (1) Enterprises with large amount of related party transaction or multiple types of related party transactions; (2) Enterprises with long-term losses, thin profit margin or fluctuating profit; (3) Enterprises with profit lower than the industry average level; (4) Enterprises with profit level that does not align with its functional and risk profile or with returns that do not correspond to cost allocated; (5) Enterprises that enter into transactions with related parties located in low-tax countries (regions); (6) Enterprises that fail to report the related party transaction or prepare contemporaneous documentation as required; (7) Enterprises with a related party debt-to-equity ratio exceeding the prescribed threshold; (8) Enterprises owned or controlled by Chinese resident enterprises or jointly controlled by Chinese resident enterprises and Chinese resident individuals, established in a country (region) with effective tax rate lower than 12.5% and do not distribute or under-distribute profits without reasonable business needs; and (9) Enterprises that implement other tax planning schemes or arrangements without proper commercial purposes.

2.16 Transfer Pricing Methods

2.16.1 Like most countries, Chinese tax administration and taxpayers are allowed to choose from the following 6 transfer pricing methods: CUP Method, RPM, CPM, TNMM, PSM and other appropriate methods. Neither does one method have priority over other methods nor does the method applied needs to be proved as the best method. Other appropriate methods include asset valuation methods through cost approach, market approach and income approach or other methods that can reflect that the profits are taxed in the jurisdiction where economic activities take places and value is created.

2.17 APA Programme

2.17.1 In accordance with the Implementation Regulation of the Tax Collection and Administration Law, the Enterprise Income Tax Law and its Implementation Regulations, Chinese taxpayers can enter into APAs with tax administration on the pricing principles and calculation methods for related party transactions for future years. The APA process involves the following 6 stages: pre-filing meeting, intent submission, analysis and evaluation, formal application, negotiation and signing, implementation and monitoring. There are 3 types of APAs that are available: unilateral APAs, bilateral APAs and multilateral APAs. An APA generally covers related party transactions for 3 to 5 consecutive years in the future. Per taxpayer's application, the APA can be retrospectively applied to the prior years not exceeding 10 years. The general threshold which a taxpayer needs to meet in order to apply for an APA is that the amount of annual related party transactions should be more than RMB 40 million for the past 3 years prior to the application year.

2.17.2 Chinese tax administration can prioritize the acceptance of an APA application from a taxpayer if it falls into one of the following categories. (1) The taxpayer's annual reporting of related party dealings and contemporaneous transfer pricing documentation are well completed with adequate disclosures. (2) The taxpayer has a level A tax credit rating. (3) Special tax investigation on the taxpayer was conducted and closed. (4) Renewal application was submitted by the taxpayer upon expiration of the existing APA with no substantial change to the facts and circumstances specified in the existing APA. (5) Information and documents submitted by the taxpayer are complete and adequate; value chain analysis and supply chain analysis are clear and thorough; location specific factors including location savings and market premium, etc. have been given adequate consideration; and the proposed transfer pricing method and the calculation method are appropriate. (6) The taxpayer can actively cooperate with the tax authorities during the APA process. (7) For a taxpayer applying for a bilateral APA, the competent authority of the relevant treaty partner has displayed strong intention to move forward with the APA negotiation and attach importance to the case. (8) There are any other factors present that could benefit the negotiation and signing of the APA requested by the taxpayer.

2.17.3 Chinese tax administration attaches great importance to the implementation of APA. Upon expiration of the APA, if the weighted average operating profitability of the enterprise during the term of the advance pricing arrangement falls below the median of the interquartile range and are not adjusted to the median, tax authorities will decline the renewal application.

2.18 MAP Process

2.18.1 In accordance with the relevant provisions in the tax treaties, the STA provides MAP assistance to both requests submitted by the taxpayers and requests initiated by the competent authorities of the treaty partner. Aimed to prevent or eliminate double taxation resulted from transfer pricing adjustments, the STA would consult with the competent authorities of the treaty partner to resolve the disputes. One area which MAP can be applied to is taxation resulted from transfer pricing adjustments that may require corresponding adjustments from the treaty partner. MAP can also be used to negotiate bilateral/multilateral APAs.

2.18.2 Taxpayers who wish to request MAP assistance should complete the Application Form for Mutual Agreement Procedures and submit it with necessary documentation to the STA headquarters within the timeframe specified in the relevant tax treaties. The STA can initiate the MAP process after receiving the aforementioned documents if the submitted documentation is in accordance with provisions in the relevant tax treaties. The STA can require the taxpayers to provide additional information if the submitted documentation is found insufficient. In cases where the competent authority of the other contracting state requests to initiate the MAP process, the STA will start the MAP process upon the receipt of the formal notification if the request is in accordance with provisions in the relevant tax treaties. The STA needs to give written notification to the relevant local tax administration and inform the competent authority of the other contracting state if it decides to initiate the MAP process.

2.18.3 If an agreement is reached between the STA and the competent authority of the other contracting state under the MAP, the agreement will be forwarded to the relevant local tax administrations. The local tax administrations need to deliver the agreement to the taxpayer within 15 days from the day it receives the written notification from the STA headquarters. If there is additional tax payment (refund) involved, the local tax administration will also need to deliver the "Notification of Additional Tax Payment (Refund) Resulted from Mutual Agreement with Respect to Special Tax Adjustments" or "Notification of Additional Tax Payment (Refund) Resulted from Advance Pricing Arrangement" to the taxpayers. Moreover, the local tax administrations are responsible for ensuring the implementation of the agreements.

2.19 Part Three: Challenges Facing China and Other Developing Countries

2.19.1 China shares many things with other developing countries in terms of transfer pricing administration. As a relatively late starter in the area, China has drawn on the OECD Transfer Pricing Guidelines and the experience of developed countries. In the meantime, China has encountered many challenges including lack of appropriate comparables, quantification and allocation of location specific advantages, identification and valuation of intangibles to which solutions were not readily available in the OECD Transfer Pricing Guidelines. Now, developing countries are looking to this UN Practical Manual on Transfer Pricing to provide solutions to these challenges that are more common to them.

2.20 Major Challenges

Arm's Length Principle

2.20.1 The arm's length principle is at the core of OECD Transfer Pricing Guidelines. Most Countries including China see it as the fundamental principle in transfer pricing. The arm's length principle requires that transactions between associated companies of a same MEN group to be benchmarked to uncontrolled transactions under comparable conditions. But uncontrolled comparable transactions are often hard to find in real life. In practice, companies that perform similar functions, assume similar risks, own similar assets, and operate under comparable circumstances to the tested companies are used instead. Yet most times the comparability of the comparable companies found could still be called to question.

2.20.2 The arm's length principle dates back to as early as the 1920s when there were very few MNEs and hence very few related party transactions. It was much easier to find independent comparables back then. The introduction of the arm's length principle had pointed out a workable direction for tax practitioners to resolve the thorny issue of transfer pricing. However, after almost a century, the application of the arm's length principle has become more challenging as the number of MNEs grew. The statistics shows that over 2/3 of the world trade involves MNEs. More than 50% of the world trade involves related party transactions. With more and more companies poised to conduct business on a group level, economic activities are more and more likely to take place in the inner circle of MNE groups. It is nearly impossible to take out one piece of a value chain of a MNE group and try to match it to third-party transactions or independent companies. Take a pharmaceutical group as an example. Suppose the parent company developed a new formulation and has contracted a subsidiary to use the formulation to manufacture the drug. The question is how much royalty should the subsidiary pay for the use of the formulation in the manufacturing. The arm's length principle can hardly be applied here as there are no comparable transactions on the market to be found because the parent company would not give the formulation to a third-party company to manufacture.

2.20.3 The challenges to the arm's length principle are not something unique to developing countries. Developed countries are facing it as well since the trend for companies to work as MNE groups to conduct cross-border transactions does not discriminate between developed and developing countries. It is just that the developing countries are dealing with the challenges with more difficulty as this chapter will explain later in more detail.

2.20.4 The biggest shortfall of applying the arm's length principle is that it may leave taxpayers uncertain about whether the pricing of related party transactions or the profit of the related companies is reasonable. In fact, no one has a definite answer. Most audits or MAP cases are the result of compromises between tax administrations and taxpayers or competent authorities of two/more countries.

Lack of Reliable Comparables

2.20.4 One of the key challenges for developing countries is the lack of reliable, public information on comparables. For a developing country, there are usually only a small number of public companies, while information on domestic private companies is lacking or inadequate. This limits the amount of publicly available information on domestic companies that can be used for transfer pricing analysis. Take China as an example. Up till the end of 2019 , there are about 4000 listed companies in China whereas the private companies are not bound by law to disclose financial information to the public. It is unrealistic to expect that reliable comparables to the tested companies can be found in 4000 listed companies. In particular, there would be a lack of comparables for companies who are first movers in an industry not yet fully exploited. In practice, foreign companies are often used as an alternative to domestic comparables. As a result, comparables sets are often dominated by companies in developed countries, simply because there are usually a much larger number of public companies in these countries.

2.20.5 While globalization and free capital mobility are the basis for the use of foreign comparables, the existence of foreign exchange controls in many developing countries violates this precondition. Accordingly, significant comparability adjustments may be necessary for companies in developed countries to be used as comparables for companies in developing countries. In some cases, it may require a different methodology such as profit split as no sufficiently reliable comparability adjustment may be feasible.

2.20.6 One of the most common adjustments in China is accounting for differences in geographic comparability when applying profit based transfer pricing methods, such as the TNMM, to determine an arm's length price. For example, when an Asia Pacific set of companies is used to benchmark the transfer prices of a Chinese taxpayer, it often includes companies from both developed countries (such as Japan and Korea), as well as developing countries (such as Indonesia and Vietnam). Generally speaking, the Asia Pacific set is more likely to contain companies from developed countries due to a greater number of listed companies in those countries and hence there is a greater volume of publicly available financial information.

2.20.7 China takes the view that there may be instances where the differences in geographical markets are so material that it warrants comparability adjustments to bridge the differences. By making such comparability adjustments, taxpayers in developing countries can overcome the practical difficulties in applying the arm's length principle to their transfer pricing analysis.

Location Specific Advantages

2.20.8 The globalization of trade and economies has given rise to concepts such as "location savings", "market premium," and more generally, location specific advantages ("LSAs"). The LSAs are advantages for production arising from assets, resource endowments, government industry policies and incentives, etc. which exist in specific localities. For example, household electronics manufacturers invest in China to take advantage of a large pool of well-educated low-cost labour and a well-developed network of suppliers, or global automotive companies set up joint ventures ("JVs") in China to assemble automobiles locally to be close to the market and the customers and to take advantage of lower costs. Limited guidance is available on these concepts in the OECD Transfer Pricing Guidelines. It has been seen that certain issues such as location savings and market premium arise more frequently in China and other developing economies, rather than in established and developed economies (which comprise the bulk of the membership of the OECD). Location savings are the net cost savings derived by a MNE when it sets up its operations in a low-cost jurisdiction. Net cost savings are commonly realized through lower expenditure on items such as raw materials, labour, rent, transportation and infrastructure even though additional expenses ("dis-savings") may be incurred due to the relocation, such as increased training costs in return for hiring less skilled labour.

2.20.9 Market premium relates to the additional profit derived by a MNE by operating in a jurisdiction with unique qualities impacting on the sale and demand of a service or product.

2.20.10 In dealings with Chinese taxpayers, the Chinese tax administration has adopted a four-step approach on the issue of LSAs:

i. Identify if an LSA exists;
ii. Determine whether the LSA generates additional profit;
iii. Quantify and measure the additional profits arising from the LSA; and
iv. Determine the transfer pricing method to allocate the profits arising from the LSA.

2.20.11 In determining LSAs and their impact on transfer pricing, both industry analysis and quantitative analysis are critical.

2.20.12 The automotive industry is a good example where there are many LSAs that have led to extraordinarily high profits that are rightly earned by Chinese taxpayers. The LSAs include:

i. The "market-for-technology" industry policy, which requires foreign automotive manufacturers to form JVs in order to assemble automobiles in China, forcing foreign automotive manufacturers to compete for limited market access opportunities by offering favourable terms including provision of technologies at below market price;
ii. Chinese consumers' general preference to foreign brands and imported products—this general preference, as opposed to

loyalty to a specific brand, creates opportunities for MNEs to charge higher prices and earn additional profits on automotive products sold in China;

iii. Huge, inelastic demand for automotive vehicles in China due to the large population and growing wealth of the population;

iv. Capacity constraints on the supply of domestically assembled automotive vehicles;

v. Duty savings from the lower duty rates on automotive parts (e.g. 10%) compared to imported vehicles (e.g. 25%)—when MNEs manufacture products in China as opposed to importing the products from outside of China, they are able to generate overall savings from the lower duty rates, even if the MNEs incur manufacturing costs and sell their domestically-manufactured products at a lower sales price compared to a foreign-manufactured vehicle; and

vi. A large supply of high quality, low costs parts manufactured by suppliers in China.

2.20.13 For a 50/50 JV with partners having conflicting interest in the Chinese automotive industry, the Chinese JV partner generally contributes local distribution network, intimate knowledge about the local market, and the right market access. However, it does not typically have control of the JV operation, which is usually controlled by the foreign JV partner. The foreign JV partner also controls the supply chain of the parts. To the extent there could still be potential transfer pricing issues, the primary issue involves the JV being overcharged for the parts and services that are provided by related parties. In the absence of such overcharges, the JV's results mainly reflect an arm's length outcome, which in turn reflect the contribution of LSAs to the JVs.

2.20.14 A further example can be that of a Chinese taxpayer performing contract research and development ("R&D") services for an offshore affiliate, and the full cost mark-up ("FCMU") as the profit level indicator for a comparable set comprising of foreign companies located in developed countries (and hence, incurring higher costs). The following example outlines the steps to calculate the adjusted FCMU taking into consideration of the location savings.

2.20.15 It is assumed that the Chinese taxpayer's cost base was 100, the average cost base for the company's R&D centres in developed countries was 150, and the median FCMU of the comparables was 8%. The comparison of the cost base between the Chinese taxpayer and that of the foreign companies is measured on an equal platform, such as the total costs (labour, raw materials, land and rent, etc.) per unit of output.

Steps Calculations

	Steps	Calculations
i	Calculate the arm's length range of FCMUs based on foreign comparables, mostly in developed countries	Assume the median FCMU is 8%
ii	Calculate the difference between the cost base of the Chinese taxpayer (e.g. 100) and the average cost base of the foreign companies (e.g. 150)	150 – 100 = 50
iii	Multiply the arm's length FCMU (e.g. 8 %) with the difference in the cost bases (50)	8% × 50 = 4
iv	The resulting profit is the additional profit (i.e. 4) attributable to China for location savings	4
v	Determine the total arm's length profit for the Chinese taxpayer	4 + 8% × 100 = 12
vi	Determine the adjusted arm's length FCMU for the Chinese taxpayer	12/100 = 12%

2.20.16 The Chinese tax administration has come across many other cases of market premiums for Chinese taxpayers, particularly in the luxury goods, pharmaceutical and automotive industries. These three industries have gained significant momentum over the past decade with booming demand from the market. Many MNEs have set up sales subsidiaries which have been involved in heavy marketing and sales activities to build the brand image among Chinese customers and cultivate their appetite for the MNEs' products. The exponential growth in sales revenue has brought in additional profits for the MENs. Given that the taxation should follow value creation, the Chinese tax administration takes the view that the additional profits should be taxed in China if they are derived from the unique characteristics of Chinese market. For example, the Chinese subsidiaries of some luxury brands have undertaken significant promotion activities to educate Chinese customers who had known nothing about the brands before. With more and more Chinese customers now are familiar with the brands and products, sales revenue has experienced great increase for the Chinese subsidiaries. On the other hand, deterred by the high prices set by the MNEs in the Chinese stores, some Chinese customers who would have went to luxury stores in China instead chose to go abroad. The money spent by Chinese shoppers in overseas luxury stores has been growing at the fast rate and constituted a sizeable portion of sales revenue of overseas affiliates. This portion of the sales revenue and the profits realized thereof should be attributed to the marketing contribution made by Chinese subsidiaries.

2.21 Intangibles

2.21.1 Intangibles are as major an issue for developing countries as they are for developed countries. While MNEs in developed countries often have superior technology intangibles, they need the fast growing market in the developing countries and contribution of the subsidiaries in these countries to develop the market in order to monetize the value in such intangibles. For developing countries, marketing intangibles and LSAs are often closely integrated, and due consideration is necessary to properly compensate the contribution of the subsidiaries in developing countries.

2.21.2 MNEs often provide intangibles to their Chinese affiliates in the initial stages of the local operation to help establish the business in China. These intangibles may take various forms, such as global brand name, technical know-how or business processes. Over time, the local Chinese subsidiaries acquire the skill and experience from operations in China, and may even contribute to the improvement of the MNE's original intangibles. The issue in this scenario is whether the local Chinese affiliates should be entitled to additional profit, and if so, what is the appropriate method to calculate the additional profit?

2.21.3 For example, if a Chinese affiliate was charged a 3% royalty for the use of a manufacturing process when the Chinese operations were established 10 years ago, then it may not be reasonable for the Chinese affiliate to continue paying the same royalty in the current year without revisiting whether the intangible has continued to provide the same value over time. This is particularly the case if the Chinese affiliate has improved a manufacturing process provided by its parent company, through a process of trial and error and conducting manufacturing operations over a 10-year period. The Chinese tax administration would question whether the Chinese affiliate should continue to pay a royalty to the parent company for the manufacturing process, or whether the Chinese affiliates should be entitled to a return on the intangibles that they have developed and shared with the group companies.

2.21.4 The Chinese tax administration is glad to see that the updated OECD Transfer Pricing Guidelines on intangibles has made it clear that entities involved with the development, enhancement, maintenance, protection and exploitation of intangibles should be compensated for their contributions. The value of an intangible developed by the parent company might be enhanced, maintained, protected and exploited by the local subsidiaries.

Developing countries need to give special consideration to the value creation to intangibles contributed by these economic activities undertaken by the local subsidiaries.

2.22 Practical Issues and Solutions

2.22.1 In a globalizing economy, MNEs usually set up operations in developing countries to take advantage of comparative advantages that these countries offer. For example, they set up manufacturing operations to take advantage of the abundant cheap labour or natural resources to supply products for overseas markets, R&D to take advantage of local talent for overseas principals, and distribution of imported products to the local market. These operations often take the form of contract or toll manufacturing, contract R&D, and limited risk distribution to leave little profit to the local country, despite the fact that many such comparative advantages contribute significant profits to the MNE group. The following paragraphs share some of the Chinese experience in dealing with these transfer pricing issues.

2.22.2 A holistic view of functions and risks may need to be taken. Many MNEs have set up multiple companies in China with each company performing only a single function, such as manufacturing, distribution, R&D, and services, and claim that each of these entities is entitled to a limited return. Others have some or all of manufacturing, distribution, R&D, and services functions in one entity, and still claim that each of these functions is entitled to only a routine return. The Chinese tax administration takes the view that when a group has multiple single function entities, they may have to be taken into consideration as a whole in order to properly determine the return the group of companies should earn in China. Similarly, an entity with multiple functions may have to be reviewed in its entirety in order to properly determine its returns.

2.22.3 While China generally respects the limited risk characterization of sole function entities[153]; determining an adequate return for such entities is a challenge, as explained below. Further, China's legislation has a specific article in its transfer pricing rules to require that such entities should not bear risks or suffer from losses arising from strategic failures, capacity under-utilization, or holdup in the sales of products, etc. if they do not perform business strategy decision making, product R&D, or sales functions. Simply put, if their upside is limited, their downside should be limited too. Contract R&D is an area where the contribution of developing countries

[153] For example, toll or contract manufacturing, limited risk distribution, or limited risk service provider.

is often underestimated. The transfer pricing method commonly used to reward R&D activities performed by a subsidiary of a MNE in China is cost plus. Sometimes, it has been found that the principal entity that is claimed to be responsible for the R&D has neither the technical expertise nor the financial capacity to be responsible. In other instances, the Chinese entity has obtained "high and new technology status" in Chinese law and therefore enjoys tax incentives on the basis of ownership of valuable core technology. However, it also claims to be a contract R&D service provider with no valuable intangibles. These are but a few examples where a cost plus approach would not be adequate. It is expected that companies claiming high tech status should be performing activities that result in the creation of intellectual property of which they can claim economic or legal ownership. It is not sufficient by itself that the contract R&D entity has shifted the majority of its risks (e.g. unsuccessful research) to its entrepreneurial related party. A proper analysis of the value provided by the contract R&D entity to the overall group operations should be conducted to determine the appropriate arm's length return for the R&D entity.

2.22.4 Contract manufacturing is one of the most common forms of manufacturing used by MNEs in China, particularly dealing with manufacturing products for export. In evaluating a contract manufacturer's return, the TNMM is often used as the transfer pricing method with the FCMU being the most commonly used profit level indicator.

2.22.5 The arm's length principle involves testing controlled transactions with uncontrolled transactions to determine how independent parties would have acted in broadly comparable situations. This principle becomes challenging to apply where a company relies on its related parties for both input purchase and output sales. If such a company is to be evaluated on a cost plus basis, a low intercompany purchase price results in an undervalued cost base that will ultimately under-compensate the contract manufacturer. However, the reasonableness of the purchase price is often difficult to assess. A further issue therefore arises on how the reasonableness of a taxpayer's intercompany arrangements in this situation should be evaluated.

2.22.6 The Chinese approach to evaluating such companies is to start with the general presumption that the related party purchase price of materials is at arm's length, and evaluate the reasonableness of the mark-up earned by the contract manufacturer on its cost base. The rationale for accepting the related party purchase price is that Customs can act as a check on the reasonableness of the import price of materials and safeguard against unreasonably low intercompany purchase prices. The next step is to proceed with the transfer pricing analysis by adopting a cost plus methodology and using the FCMU as the profit level indicator. The challenge that follows lies in the search for suitable comparable companies, as discussed earlier in this paper.

2.22.6 Toll manufacturing is a common form used by MNEs in developing countries, but its proper return is difficult to determine since there are only a few independent listed companies that perform such activities. Some taxpayers simply use the FCMU for contract manufacturers as the mark-up for toll manufacturers. This grossly underestimates the return to toll manufacturers. Others use return on assets as a profit level indicator based using contract manufacturers as comparables, and this may also underestimate the return, particularly for labour intensive toll manufacturers as often being the case in developing countries.

2.22.7 In practice, the Chinese tax administration has sought to first estimate the total cost of the toll manufacturing operation as if it were a contract manufacturer, usually by adding back costs of raw materials which may be obtained from Customs. It then estimates the appropriate returns (say, FCMU) for contract manufacturing based on contract manufacturing comparables, and apply this to the estimated total cost to arrive at the total contract manufacturing profit, from which it then adjusts for factors such as inventory carrying costs, to arrive at the total profit for the toll manufacturer. This approach works well when reliable customs information on raw materials is available. If customs information on raw materials is not available or not reliable, then there are unresolved issues as to what should be an appropriate profit level indicator and how it could be derived.

2.22.8 Sales, marketing and distribution are another set of functions where it has been seen that MNEs often underestimate the contribution of developing countries. Chinese experience shows that many MNEs treat its Chinese distribution entities as a limited risk distributor, and use a set of simple distributors performing limited functions in a mature market such as Japan as the comparables. There are a couple of obvious deficiencies in such an approach. First, there often is a mismatch in terms of functional profile, as the Chinese entity may perform significantly more functions than these so-called comparables, which is evident as it incurs significantly more operating expenses relative to sales. Second, it does not account for market differences, with China being a fast growing economy and having strong demand which requires relatively less selling effort and therefore can achieve higher efficiency and profitability. Other LSAs such as country premium and any marketing intangibles that are created by the Chinese entity are also commonly ignored.

2.22.9 In practice, the Chinese tax administration has attempted to correct such deficiencies by using a more appropriate transfer pricing method, such as profit split in the cases where significant local marketing intangibles or LSAs is identified, or performing comparability adjustments when TNMM is used. For example, if the median operating expense to sales ratio for the comparable set is only 7%, and the same ratio for the taxpayer was 40%, to the extent there is location savings, the Chinese tax administration would adjust the cost base first. The Chinese tax administration would then calculate the additional return required for the extra efforts made by the Chinese taxpayer to derive the total return for the Chinese taxpayer.

2.23 Alternative Methods to the Traditional Transactional Net Margin Method (TNMM)

2.23.1 While the TNMM may still be used when there is a lack of adequate local comparables, such as using foreign comparables with proper adjustments, as in the contract R&D example, sometimes a different method such as the profit split may be more appropriate. An example is the electronic manufacturing services ("EMS") sector, where the entire, or nearly the whole manufacturing and assembly activities of a foreign EMS MNE group, have been outsourced to its Chinese affiliates.

2.23.2 The typical set up for these manufacturing and assembly operations is such that the majority of the work force and tangible assets of these foreign EMS MENs are located in China, including many high level operational staff. The headquarters of these EMS companies are located outside of China, with the EMS group's revenues supported by significant manufacturing contracts with third-party global consumer electronics companies. Often, in such instances, the MNE group's transfer pricing policies have little regard for properly compensating the Chinese manufacturer. The profits of the Chinese manufacturer are stripped away as much as possible on the basis that the manufacturer is a contract manufacturer or a toll manufacturer with a very low risk profile.

2.23.3 Under this scenario, China takes the view that a risk based approach may place insufficient regard for the fact that there are sizeable assets located in China (i.e. the work force and factory plants). In many cases, the majority of the headcount of the EMS group are based in China, with only a few management personnel residing outside of China. Rather than a transactional or profits based approach, a contribution analysis approach may be more suitable. This means that remuneration to each party involved would be commensurate with its role and contribution to the value chain in the group. In this case, the assets and the people should largely dictate where the group's profits should stay, and a global formulary approach should be a realistic and appropriate option.

2.23.4 Alternatively, the Chinese tax administration may determine the proper return for the headquarters, with the Chinese manufacturer earning the residual profits. Another potential alternative may be to evaluate the Chinese manufacturer on the return on its assets or capital employed, using the group's results as a comparable for the Chinese manufacturer.

2.24 Other Experience and Recommendations

2.24.1 One of the key issues faced by developing countries is the lack of experience and knowledge on how MNEs operate and on a particular industry. Transfer pricing is commonly acknowledged as one of the most difficult international tax issues, and MNEs as well as tax administrations in developed countries have developed and dedicated substantial resources including talents to this area. The Chinese experience has been that a dedicated team, with accounting, economics, and industry background would be very critical, in order for tax administrations in developing countries to effectively administer their transfer pricing rules.

2.24.2 Issues such as location specific factors further raise the stakes. To effectively deal with such issues, solid economic and quantitative analyses are necessary. Compared with MNEs, which have vast resources at their disposal to hire the best professionals, and with tax administrations in developed countries which also have developed a large team of economists and quantitative analysts, developing countries such as China have a clear disadvantage, which has to be fixed urgently. As explained earlier in this paper, the STA has committed to putting in place a dedicated team by adding more staff and resources. Also, in order to assure the consistency in transfer pricing administration, substantial cases are centrally approved by specialist panel either at provincial level or national level depending on the significance of the cases.

2.24.3 One way to address the disadvantages faced by developing countries in transfer pricing is to extend the statute of limitations. For example, the statute of limitations for corporate income tax is normally five years in China. However, the statute of limitation for transfer pricing has been extended to ten years, allowing more time for tax administration to check on taxpayers' transfer pricing issues. Another way is to set clear compliance and penalty rules, putting the burden of proof on taxpayers and encouraging taxpayers to be in compliance and make self-adjustments when needed. It has been found that contemporaneous transfer pricing documentation requirements coupled with penalty rules have been very effective in encouraging taxpayer compliance. An industry wide or a group wide audit has also been a very effective and efficient way for the tax administrations to make the best use of its limited resources.

2.24.4 As an emerging market economy, China's has established a three-pronged tax avoidance prevention and control system with consistent and standardized approach for administration, service and investigation. As the second part of this paper states, China does not always have the same technical expertise and resources that developed countries possess. Nevertheless, experience on transfer pricing in China is accumulating quickly. The underlying objective in conducting audits is to show Chine's resolve to enforce tax compliance and to remind the MNEs to take into account Chinese companies' contribution to the global profit when determining the transfer pricing policies.

2.25 Conclusion

2.25.1 The BEPS project has reshaped the international tax landscape in an unprecedented manner, and the ongoing work on addressing the tax challenges arising from the digitalization of economy will further change the status quo. In the time when the globalization is at the crossroads, combined with the trade frictions among countries and severe impact of Covid-19 pandemic, the MNEs are likely to be pressured to rethink their global operation and value chain distribution. This will in turn bring in new challenges, especially in the area of transfer pricing that the tax administrations of developing countries will need to deal with.

2.25.2 The Chinese tax administration appreciates the opportunity to share with fellow developing countries the experience and insight on transfer pricing administration, and welcomes inputs that could provide useful perspectives.

3 India—Country Practices

Transfer Pricing Practices and Challenges in India

3.1 Introduction

3.1.1 Transfer pricing provisions were introduced in the Indian Income-tax Act in 2001. The provisions were broadly aligned with the OECD Transfer Pricing Guidelines. Over the years, transfer pricing audits in India have brought up a number of issues and challenges. Administration of transfer pricing laws has also resulted in several disputes and protracted litigation. With a view to reducing transfer pricing disputes, many initiatives have been introduced by the tax administration. Some of the initiatives are the introduction of an Advance Pricing Agreement (APA) scheme, inclusion of safe harbour provisions, utilization of the Mutual Agreement Procedure (MAP) provision in bilateral tax treaties to resolve transfer pricing disputes, migration from a quantum of transactions-based selection to risk-based selection of transfer pricing cases for audit, and issuance of various Circulars and Instructions on transfer pricing matters to provide clarity on transfer pricing issues, etc.

3.1.2 Owing to these initiatives, there has been an impact on the number of cases under audit as well as the number of disputes arising from such audits, which have both shown a downward trend. The Indian tax administration has a robust system of identifying high-risk transfer pricing cases, while providing a reasonable degree of certainty to low risk taxpayers. The new approach is expected to raise the quality of transfer pricing audits without creating an environment of tax uncertainty and protracted litigation.

3.1.3 Various aspects pertaining to the transfer pricing regime in India and the outstanding issues that continue to pose challenges to the transfer pricing administration are discussed in the subsequent paragraphs of this chapter.

3.2 Transfer Pricing Regulations in India

3.2.1 The Indian Transfer Pricing Regulations are based on the arm's length principle. The regulations came into effect from 1 April 2001. The regulations provide that any income arising from an international transaction between associated enterprises (AEs) shall be computed having regard to the arm's length price (ALP). The concept of "associated enterprise" has been defined in detail in the regulations.

3.2.2 The ALP is to be determined by any of the prescribed transfer pricing methods. The methods prescribed for the determination of the ALP are the following: Comparable Uncontrolled Price (CUP) Method, Resale Price Method (RPM), Cost Plus Method (CPM), Transactional Net Margin Method (TNMM), Profit Split Method (PSM) and a residual method known as "any other method". The regulations do not provide any hierarchy of the methods and support the concept of the "most appropriate method" which provides the most reliable measure of an arm's length result under a particular set of facts and circumstances.

3.2.3 The regulations prescribe mandatory annual filing requirements as well as maintenance of contemporaneous documentation by taxpayers if international transactions between associated enterprises cross a threshold, and they contain penalty implications in case of non-compliance. The primary onus of proving the ALP of a transaction lies with the taxpayer. In most cases, the Indian entity is taken as the tested party and Indian comparables are used. If the foreign associated enterprise is the less complex entity, it is taken as the tested party.

3.2.4 In order to provide uniformity in the application of transfer pricing law, there are specialized "Commissionerates"(i.e. geographical districts) under the supervision of a Principal Chief Commissioner of Income-tax (International Taxation) at Delhi and two Chief Commissioners of Income-tax (International Taxation) stationed at Mumbai and Bengaluru. Transfer Pricing Officers are vested with powers of inspection, discovery, enforcing attendance, examining a person under oath, on-the-spot enquiry/verification and compelling the production of books of account and other relevant documents during the course of a transfer pricing audit. The mechanism of the Dispute Resolution Panel is also available to taxpayers to resolve disputes relating to transfer pricing.

3.2.5 The legislature, in 2020, authorized the Government of India[154] to make a scheme that provides for team-based transfer pricing audits with elimination (to the extent feasible) of interface between the Transfer Pricing Officers and the taxpayers.[155]

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154 For the purpose of making a scheme for team-based transfer pricing audits, section 92CA of the Indian Income-tax Act, has been amended w.e.f. 1st November 2020

155 Reference is made to Faceless Assessment, Appellate and Penalty Scheme

3.2.6 The Government of India has a dedicated website which contains comprehensive information about the latest provisions of tax law and related rules, Circulars and Instructions including those related to transfer pricing. The website has a user-friendly interface.[156]

3.3 Transfer Pricing Issues in India

3.3.1 Comparability Analysis

Comparability analysis is the key to determining the arm's length price of an international transaction. However, increased market volatility and increased complexity in international transactions have thrown open serious challenges to comparability analysis and determination of the arm's length price. Some of these challenges and the responses of the Indian transfer pricing administration in dealing with these challenges are analyzed below.

3.3.2 Use of multiple-year data: With a view to avoiding disputes arising from the earlier rule of using data of only the current year, i.e., the year in which the international transaction was undertaken, use of multiple-year data has now been permitted. Thus, for transactions undertaken on or after 1st April 2014 (i.e., from Assessment Year 2015-16), multiple-year data of comparable uncontrolled transactions entered into by the comparable companies can be used for the purpose of benchmarking international transactions with associated enterprises.

The multiple-year data would include data of a maximum of three years (for example, the data of the current year and of two immediately preceding years). In certain situations, where data of all three years are not available, the data could be of two years (for example, if the data of the current year is not available, the data of two immediately preceding years) or even of one year (for example, data of only the current year or, if the data of the current year is not available, only the data of the year immediately preceding the current year). The data of one or both of the preceding years can be used only if the enterprise used as a comparable undertakes the same or similar uncontrolled transactions in the current year.

3.4 Issues Relating to Risks

3.4.1 A comparison of functions performed, assets employed and risks assumed is the basis of any comparability analysis. Indian practice has been to evaluate risk in conjunction with functions and assets. India believes that

(India), 2020, available from https://www.incometaxindia.gov.in/Pages/faceless-scheme.aspx

156 http://www.incometaxindia.gov.in

it is unfair to give undue importance to risks in determination of the arm's length price in comparison to functions performed and assets employed.

3.4.2 Identification of risks and of the party which bears such risks are important steps in comparability analysis. India believes that the conduct of the parties is key to determining whether the actual allocation of risks conforms to contractual risk allocation. Allocation of risks depends upon the ability of parties to the transaction to exercise control over such risks. Core functions, key responsibilities, key decision-making and levels of individual responsibility for the key decisions are important factors to identify the party which has control over the risks. Besides, financial capability to bear the risk is also important in establishing whether a party actually bears or controls the risk.

3.4.3 In India, Multinational Enterprises (MNEs) often make claims before the Transfer Pricing Officers that related parties engaging in contract research and development or other contract services in India are risk-free entities. Accordingly, these related parties are said to be entitled to only routine (low) cost plus remuneration. MNEs also contend that the risks of research and development (R&D) activities or services are being controlled by them and Indian entities being risk-free entities are only entitled to a low cost plus remuneration.

3.4.4 The notion that risks can be controlled remotely by the parent company and that the Indian subsidiary engaging in core functions, such as carrying out R&D activities or providing services, is a risk-free entity has not been found acceptable. India believes that in many cases the core function of performing R&D activities or providing services is located in India, which in turn requires important strategic decisions to be taken by the management and employees of the Indian subsidiaries. These strategic decisions could be in terms of designing the product or the software; the direction of R&D activities or providing services; and the monitoring of R&D activities. Accordingly, the Indian subsidiary exercises control over the operational and other risks. In these circumstances, the ability of the parent company to exercise control over the risks remotely from a place where core functions of R&D and services are not located is very limited.

3.5 Arm's Length Range

3.5.1 In order to align the Indian transfer pricing law to the best international practices, the law was amended to introduce a "Range" concept for determining the ALP, which is applicable for international transactions undertaken on or after 1st April 2014 (i.e., effective from assessment year 2015-16). The salient features of the "Range" concept are as follows:

- a dataset of the results/profit margins of six or more comparable companies are to be arranged in an ascending order and an arm's length range beginning with the thirty-fifth percentile of the dataset and ending with the sixty-fifth percentile of the data-set (the "Middle 30" of the dataset) is to be constructed;
- if the price at which the international transaction has actually been undertaken is within the range referred to above, then the price of the transaction shall be deemed to be the ALP;
- if the price at which the international transaction has actually been undertaken is outside the range referred to above, then the ALP shall be the median of all the values included in the dataset (i.e. the 50th percentile); and
- however, if the range is not used due to the non-availability of at least six comparable companies, the arithmetic mean, with a tolerance range qua (relevant to) the nature of business activities, shall continue to be used to determine the ALP.

3.6 Comparability Adjustment

3.6.1. As with many other countries, the Indian transfer pricing regulations require "reasonably accurate comparability adjustments". The onus to prove a "reasonably accurate comparability adjustment" is on the taxpayer. The experience of the Indian transfer pricing administration indicates that it is possible to provide capacity utilization and working capital adjustments. However, the Indian transfer pricing administration finds it difficult to make risk adjustments in the absence of any reliable, robust and internationally agreed methodology to provide risk adjustment.

3.7 Secondary Adjustment

3.7.1 In certain specified situations, for transactions undertaken on or after 1st April 2016 where an adjustment is made to the transfer price leading to an increase in income or reduction in the loss of the taxpayer, the excess money(i.e., the difference between the transfer price and the arm's length price) available with the associated enterprise, if not repatriated to the taxpayer in India within the specified time, is deemed to be an advance made by the taxpayer to such associated enterprise, on which interest at prescribed rates is chargeable. For transactions undertaken on or after 1st September 2019, the taxpayer also has the option to pay one-time additional income-tax at the rate of eighteen per cent on the unrepatriated excess money.

3.8 Location Savings

3.8.1 The concept of "location savings", i.e., cost savings in a low-cost jurisdiction such as India, is one of the aspects taken into account while carrying out a comparability analysis during transfer pricing audits. The expression "location savings" has a broad meaning; it goes beyond the issue of relocating a business from a "high-cost" to a "low-cost" location and relates to any cost advantage that a jurisdiction can provide. MNEs continuously search for options to lower their costs in order to increase their profits. In this respect, India provides various operational advantages to MNEs, such as availability of low-cost labour or skilled employees, lower raw material cost, lower transaction cost, reasonably priced rental space, lower training costs, availability of infrastructure at a lower cost, various direct and indirect tax incentives, etc.

3.8.2 In addition to the above cost advantages, India provides the following Location-Specific Advantages (LSAs) to MNEs:

- highly skilled, specialized and knowledgeable workforce;
- access and proximity to large and growing local/ regional markets;
- large customer base with increased spending capacity;
- superior information networks;
- superior distribution networks;
- various policy incentives; and
- market premium.

3.8.3 The incremental profit from LSAs is known as a "location rent". The main issue in transfer pricing is the quantification and allocation of location savings and location rents among the associated enterprises. Using an arm's length pricing approach, the allocation of location savings and rents between associated enterprises should be made by reference to what independent parties would have agreed in comparable circumstances. It is possible to use the PSM to determine the arm's length allocation of location savings and rents in cases where comparable uncontrolled transactions are not available. In these circumstances, it is considered that the functional analysis of the parties to the transaction (functions performed, assets owned and risks assumed), *and* the bargaining power of the parties (which at arm's length would be determined by the competitiveness of the market, availability of substitutes, cost structure, etc.) should both be considered as appropriate factors.

3.8.4 However, in situations where comparable uncontrolled transactions are available, the comparability analysis and benchmarking by using the results/profit margins of such local comparable companies will determine the ALP of a transaction with a related party in a low-cost jurisdiction. If good local comparables are available, the benefits of location savings can be said to have been captured in the ALP so determined. However, if good local comparables that could capture the benefits of location savings are not available or in situations where the overseas AE is chosen as the tested party, the issue of capturing the benefits of location savings would remain an issue in determining the ALP.

3.9 Issues Related to Cost Base Under Transactional Net Margin Method (TNMM)

3.9.1 Many MNEs have captive service centres and contract manufacturing facilities in India. As part of their transfer pricing policy, they usually reimburse the Indian entity using TNMM with the profit indicator mark-up on total costs as the most appropriate method. Under this method, a mark-up on the cost base is provided by overseas associated enterprises to the Indian company. Transfer pricing examination in India has revealed that certain costs are often not included in the cost base. As a result, the mark-up is calculated on a reduced cost base by the taxpayer. The cost base is normally changed by the Indian transfer pricing authorities to include such costs. Some of these costs are as under:

(a) *Stock-based compensation*

Under the group policy, the overseas associated enterprise sometimes pays a remuneration/performance bonus to the employees of the Indian entity through an Employee Stock Option Plan or Plans (ESOPs) or similar plans. As per the practice in India, ESOP expenses should be included in the cost base for the limited purpose of computing the mark-up, since the additional compensation is given by the overseas associated enterprise for performance of the employees of the Indian company. This is based on the principle that stock-based compensation is a part of the remuneration structure of the employees and is therefore included in the cost base for the purpose of computing mark-up in the same way as cash component of remuneration.

(b) *Third-party consultancy cost and infrastructure cost borne by the overseas AE, but report/ data/ insights from the consultancy, or facilities, used by the taxpayer in the course of business*

It has been found in some cases that the Indian company uses certain training materials, expert opinions, due diligence reports, and advisory reports, in discharge of its business. However, payments for such material/ opinion/reports are made by the overseas associated enterprise to the consultant directly. An overseas associated enterprise may also be paying for connectivity, communication channels, and other common group infrastructure. If the Indian taxpayer does not include such costs in the cost base, for the limited purpose of computing the amount of mark-up, transfer pricing authorities will make necessary changes to the cost base.

(c) *Software and assets received free of cost*

It is seen in many cases that one group entity purchases software for the entire group and shares the license with various AEs. The Indian associated enterprise may be a beneficiary of the software, but may not be paying for it. Such costs should be included in the cost base when computing the mark-up amount.

In some cases, it is seen that overseas associated enterprises provide free-of-cost assets to the Indian associate, which are then used by the Indian associate. In such situations, a depreciation on the value of such free of cost assets should be included in the cost base for limited purpose of computing the mark-up amount.

The above would apply even in situations where the software/ assets are provided at a discounted price.

(d) *Third-party vendor cost incurred by the Indian associated enterprise:*

Sometimes, a captive service company may outsource part of its work to a third-party vendor and may argue that it does not do any value addition with respect to the work outsourced to such a vendor, and is to be treated like a "pass-through entity". Consequently, it would not apply the profit mark-up on the outsourced costs.

As per the practice in India, such third-party costs should normally be included in the cost base, where they are found to be related to the functions and associated risks of the Indian entity.

3.10 Intangibles

3.10.1 General

Transfer pricing of intangibles has been a difficult area of work for tax administrations across the world. The situation has been the same for the Indian tax administration. The pace of growth of the intangible economy has opened up new challenges to the arm's length principle.

3.10.2 Transactions involving intangible assets are difficult to evaluate for the following reasons:

- intangibles are rarely traded in the external market and it is very difficult to find comparables in the public domain;
- intangibles are often transferred bundled along with tangible assets; and
- they may be difficult to detect.

3.10.3 A number of complications arise while dealing with intangibles. Some of the key issues revolve around determination of the arm's length rate of royalties, allocation of the cost of development of the market and brand in a new country, remuneration for development of marketing and R&D intangibles, their use, transfer pricing of co-branding, etc. Some of the Indian experiences in this regard are discussed below.

3.10.4 With regard to payment of royalties, MNEs often enter into agreements allowing use of brands, trademarks, know-how, design, technology, etc. by their subsidiaries or related parties in India. Such payments can be made as a lump sum or by way of periodic payments or a combination of both types of payment. Intellectual property, which is owned by one entity and used by another entity, generally requires a royalty payment as consideration for its use. However, the important issue in this regard has been the determination of the arm's length rate of royalty. The main challenge in determining the arm's length royalty rate is to find comparables in the public domain with sufficient information for comparability analysis. Further, it is difficult to find a comparable ALP in most cases. The use of the PSM as an alternative is generally not a feasible option due to the lack of requisite information.

3.10.5 Serious difficulties have been encountered in determining the rate of royalty charged for the use of brands and trademarks in certain cases. In some cases, the user had borne significant costs in promoting the brand/trademark, and in promoting and developing customer loyalty for the brand/trademark in a new market. In these cases, the royalty rate charged by the

MNE should depend upon the cost borne by the subsidiary or related party to promote the brand and trademark and to develop customer loyalty for that brand and product. In many cases, no royalty is charged from the local subsidiary in an uncontrolled environment and the subsidiary would require an arm's length compensation for economic ownership of the brand and trademark developed by it, and for enhancing the value of the brand and trademark (legally owned by the parent companies) in an emerging market such as India.

3.10.6 In many cases, Indian subsidiaries using the technical know-how of their parent company have incurred significant expenditure to customize such know-how and to enhance its value by their R&D efforts. Costs of activities, such as R&D activities which have contributed to enhancing the value of the know-how owned by the parent company, are generally considered by the Indian transfer pricing administration while determining the ALP of royalties for the use of technical know-how.

3.10.7 Significant transfer pricing issues have also arisen in cases of co-branding of a new foreign brand owned by the parent MNE (a brand which is unknown to a new market such as India) with a popular Indian brand name. Since the Indian subsidiary has developed a valuable Indian brand in the domestic market over a period of time, incurring very large expenditure on advertisement, marketing and sales promotion, it should be entitled to an arm's length remuneration for contributing to increasing the value of the little-known foreign brand by co-branding it with a popular Indian brand and therefore increasing market recognition.

3.11 Intangibles Generated Through R&D Activities

3.11.1 Several global MNEs have established subsidiaries in India for R&D activities on a contract basis to take advantage of the large pool of skilled manpower which is available at a lower cost. These Indian subsidiaries are generally compensated on the basis of routine and low cost plus mark-ups. The parent MNEs of these R&D centres justify low cost plus mark-ups on the ground that they control all the risks and their subsidiaries or related parties are risk-free or limited risk bearing entities. The claim of the parent MNEs that they control the risk and are entitled to a major part of the profits from R&D activities is typically based on the contention that they:

- design and monitor all the research programmes of the subsidiary;
- provide the funds needed for the R&D activities;
- control the annual budget of the subsidiary for R&D activities;

- control and take all the strategic decisions regarding the core functions of R&D activities of the subsidiary; and
- bear the risk of unsuccessful R&D activities.

3.11.2 In transfer pricing audits of certain contract R&D centres, the following facts have emerged:

- most parent companies of Indian subsidiaries were not able to file relevant documents to justify their claim of controlling the risk of core functions of R&D activities and assets (including intangible assets), which are located in the country of their subsidiary;
- contrary to the claims made by the parent companies, it was found that day-to-day strategic decisions and monitoring of R&D activities were carried out by personnel of the subsidiary who were engaged in actual R&D activities and bore relevant operational risks;
- the management of the Indian subsidiary also took decisions concerning the allocation of budget to different streams of R&D activities and Indian management also monitored the day-today performance of R&D activities; and
- while it was true that funds for R&D activities were provided by the parent companies that bore the financial risk of the R&D activities, the other important aspects of R&D activities, such as technically skilled manpower, know-how for R&D activities, etc. were developed and owned by the Indian subsidiaries. Accordingly, control over risks of R&D activities lay both with the parent MNE and the Indian subsidiary but the Indian subsidiary controlled more risks as compared to its parent.

3.11.3 It has thus been inferred that the Indian subsidiaries were not risk-free entities but bore economically significant risks. Accordingly, Indian subsidiaries were entitled to an appropriate return for their functions, including strategic decision-making, monitoring R&D activities, use of their tangible and intangible assets and exercising control over the risks. In view of these facts, a routine and low cost plus compensation model would not arrive at an ALP.

3.12 Marketing Intangibles

3.12.1 Transfer pricing aspects of marketing intangibles have been a focus area for the Indian transfer pricing administration. The issue is particularly relevant to India due to its unique market specific characteristics such as location advantages, market accessibility, large customer base, market premium, spending power of Indian customers, etc. The Indian market has witnessed substantial marketing activities by the subsidiaries/related parties of MNE groups in the recent past, which have resulted in creation of local marketing intangibles.

3.12.2 The functions carried out by Indian subsidiaries of an MNE Group relating to marketing, market research and market development, including adding value to intangibles such as brands, trademarks and trade names owned by parent companies, as well as creation and development of marketing intangibles like customer lists and dealer networks, have been the subject matter of transfer pricing adjustments in India. The expenditure incurred on these marketing functions has been considered for adjustment by Indian tax authorities on the premise that the Indian taxpayers were incurring these expenses for and on behalf of their parent companies outside India, and that:

- these expenses promoted the brands/ trademarks that are legally owned by the overseas associated enterprises; and
- these expenditures created or developed marketing intangibles in the form of brands/ trademarks, customer lists, dealer/distribution channels, etc. even though the Indian company may have had no ownership rights in these intangibles.

Based on this premise, it has been held by the Indian tax authorities that the functions carried out, which are in the nature of development of the relevant intangibles, deserve compensation.

3.12.3 For computing the value of compensation and the required adjustment, a comparison with the average Advertisement, Marketing and Promotion (AMP) spends by comparable businesses in a broadly similar line of business has been made to determine the routine spend on AMP for product sale. The expenditure over and above this has been held to be purely incurred for developing the brand value or other marketing intangibles for the benefit of the associated enterprise and as a service to it. Such excess expenditure has been considered for adjustment along with a mark-up as a service charge on the same, worked out on a cost plus basis. The understanding going into this approach has been that functions relating to development, enhancement and exploitation of marketing intangibles, now termed as DEMPE (Development, Enhancement, Maintenance, Protection and Exploitation) functions under the BEPS Final Report on Action Point 8 to 10, result in the following two-fold benefit to the AEs:

1) Direct Benefit: by way of increased revenue from the territory on account of Sale/Royalty/Fee for Technical Services, etc. In many of the cases, such functions may have an impact on revenue

enhancement of the associated enterprises in other parts of the world. For example, sponsorship of events or sports watched in many countries, launching of brands developed in India in other parts of the world, etc.

2) Indirect Benefit:

   a. Development of Market: the associated enterprises, who are owners of intangibles, obtain an advantage in terms of development of the market for themselves. While this kind of advantage builds over a period of time, it is manifested in different ways. For example, when the associated enterprise enters into an agreement with a third-party for directly selling goods in India, it is observed in many cases that agreements are concluded in India by the foreign associated enterprises with retail chain companies or e-sellers or large corporate houses, etc. Here, the awareness about the trade intangibles owned by the associated enterprise, which were not well-known in the Indian market, is enhanced by the marketing efforts made by the Indian taxpayer, thus adding value to the intangibles. This practice of the Indian subsidiary also creates a platform for the associated enterprise when it launches new products in India. Although some of the Indian taxpayers are being compensated partly and some of them are not, invariably no separate accounts are maintained by the taxpayer to show which part of the expenditure pertains to the DEMPE functions related to the intangibles and consequent benefits provided to the associated enterprise and which is incurred for routine promotion of the product. The pattern of compensation, if any, by the associated enterprises for such functions is varied. While some of them provide a subsidy to the Indian subsidiary to maintain an agreed profit level, others grant a lump sum compensation which is generally not correlated by the taxpayer to functions discharged by it; and

   b. Enhancement of Exit Value: The marketing activity of the taxpayer bestows another kind of advantage to the associated enterprise which is realized when there is a change in ownership of the business — either by way of restructuring within the group or by way of divesting either a part or full business to a third-party. At this stage, the exercise of market development, brand development or other value additions to the intangibles like copyrights, patents, trademarks, licences, franchises, customer list, marketing channel, brand, commercial secret, etc. are of tremendous importance while negotiating the price of divestment and valuation of assets.

3.12.4 The adjustments made by Transfer Pricing Officers have been subject to judicial reviews in India and although the matter is still to be finally adjudicated by the Supreme Court, the following principles have emerged from the decisions of the High Courts and Tribunals:

1) The existence of an international transaction in relation to any service or benefit will have to be established before transfer pricing provisions can be applied to place a value on the service or benefit for the purpose of determining compensation; and
2) The mere fact of unusual or excessive AMP expenditure cannot establish the existence of such a transaction. However, once such a transaction is established, it is possible to benchmark it separately and it need not always be aggregated with other international transactions.

3.12.5 The present approach of the Indian tax administration for carrying out transfer pricing adjustments in accordance with the above judicial principles is as follows:

- carrying out a detailed Functions, Assets, and Risks (FAR) analysis to identify all the functions of the taxpayer and the associated enterprises pertaining to all international transactions, e.g., purchase of raw material/components, payment of royalty, purchase of finished goods, export of finished goods, support services, direct sales by the associated enterprise in India, etc.;
- examining whether the marketing activities, marketing research, market development, distribution channel, dealers channel, customer list, etc. (DEMPE functions) reflected by the expenditure incurred by the taxpayer and the associated enterprise in India are in conformity with the functional and risk profiles and the benefits derived by the taxpayer and the AE, and whether the AE, assuming a risk in the Indian market or benefitting from India in one way or the other, is dependent upon the DEMPE functions carried out by the Indian subsidiary; and
- finding the most appropriate method to determine the arm's length compensation for the functions performed, assets used or contributed, and risks assumed by the Indian entity. The most appropriate method would depend on the facts of the case. Where the TNMM is found to be the most appropriate method,

one of the approaches adopted by tax authorities is comparison of the intensity of AMP functions of the taxpayer with that of comparable entities by comparing their respective marketing and related expense as a percentage of revenue. Only after the appropriate adjustment, the operating profit ratios of the comparables are compared with the operating profit ratio of the taxpayer. In several cases, where residual PSM is held as the most appropriate method, the tax authorities first identify the non-routine AMP expense of the taxpayer by comparing its AMP expense with that of comparable entities performing routine manufacturing/ distribution activity. Non-routine AMP expense, if any, is excluded from the operating expense of the taxpayer and the resulting operating profit margin is compared with the operating profit margin of comparable entities performing routine manufacturing/ distribution activity. If any residual profit is identified as a result of such comparison, it is split between the taxpayer and its associated enterprise in the ratio of the marketing related functions performed, assets used or contributed and risks assumed by them. In case the taxpayer's share of residual profit combined with its routine profit exceeds the profit declared by it, an adjustment is made.

3.12.6 The BEPS Report on transfer pricing issues illustrates through examples, the situations in which a marketeer/distributor can expect compensation for the AMP functions carried out by it. The common threads arising from these examples are:

- Compensation for the AMP function will depend on the intensity with which the function is performed, the extent of assets employed and the amount of risk borne by the parties in respect of the AMP function;
- Compensation can be part of the price of another transaction. For example, the taxpayer could be compensated by way of reduced price of goods or raw material or through a reduced rate of brand royalty;
- The taxpayer may be compensated directly for the excess marketing expenditure it incurs over and above that incurred by comparable independent enterprises, along with an appropriate mark-upon such expenditure;
- The combined profits from sales of goods can first be split by giving the distributor and the associated enterprise that owns the brand a basic return on their functions. The residual profit

can then be split taking into account the relative contributions of both entities to the generation of income and the value of the brand or trademark; and

- Where the results of the AMP function performed by the taxpayer are entirely exploited by the taxpayer itself, no separate compensation is receivable for the function.

The entity that takes the important decisions relating to the AMP function such as deciding the strategy, fixing the budget and exercising overall control over the function is the entity that bears the risk relating to the AMP activity and is entitled to all the excess profits generated on account of the function.

3.12.7 The Indian tax administration keeps these principles in view to make adjustments but it is apparent that the process is complex, fact intensive and not free from disputes. The efforts being made by the Indian tax authorities to bring uniformity in approach and the expected judicial verdict from the Indian Supreme Court are likely to bring more clarity in the process.

3.13 Intragroup Services

3.13.1 Globalization and the drive to achieve efficiencies within MNE groups have encouraged sharing of resources to provide support to group entities in one or more locations by way of shared services. Some of the services are relatively straightforward in nature, such as marketing, advertisement, trading, management consulting, etc. However, other services may be more complex and can often be provided either on a stand-alone basis or as part of a package and are linked one way or other to the supply of goods or intangible assets.

3.13.2 The following questions are relevant to identify intragroup services requiring arm's length remuneration:

- have the Indian subsidiaries received any related party services, i.e., intragroup services?
- what are the nature and details of services, including the quantum of services received by the related party?
- have services been provided in order to meet the specific needs of the recipient of the services?
- are they duplicate services (i.e., was the Indian subsidiary availing similar services on its own)?
- did the Indian subsidiary have the capacity to absorb the services provided by the AE?

- what are the economic and commercial benefits derived by the recipient of intragroup services?
- in comparable circumstances, would an independent enterprise be willing to pay for and procure such services?
- would an independent third-party be willing and able to provide such services?

3.13.3 The answers to the above questions help in determining if the Indian subsidiary has received or provided intragroup services that require arm's length remuneration. Determination of the ALP of intragroup services normally involves the following steps:

- identification of the cost incurred by the group entity in providing intragroup services to the related party;
- understanding the basis for allocation of cost to various related parties, i.e., the nature of "allocation keys" used by the MNE;
- considering whether intragroup services will require reimbursement of expenditure along with mark-up; and
- identification of the ALP of a mark-up for rendering such services.

3.13.4 Identification of the services requiring arm's length remuneration is one of the main challenges for the transfer pricing administration. India believes that shareholder services, duplicate services and incidental benefits from group services do not give rise to intragroup services requiring arm's length remuneration. However, such a conclusion would need a great deal of analysis. The biggest challenge in determination of the arm's length price is the allocation of cost by using allocation keys. The nature of allocation keys generally varies with the nature of services.

3.13.5 Another challenge for the transfer pricing administration is the identification of pass-through costs, on which mark-ups either should not be paid (if the Indian entity is the recipient of such services) or not received (if the Indian entity is the service provider). Wherever a mark-up is to be paid or received, the determination of an arm's length mark-up is also a challenge.

3.13.6 Payments for intragroup services received are recognized as one of the riskiest international transactions to price. Hence, different perspectives are carefully examined by the Indian tax administration in a transfer pricing audit of such payments. Firstly, the cost charged out by the associated enterprises to Indian subsidiaries is carefully evaluated. As mentioned above, the composition of such costs, removal of duplicative and shareholder costs from the cost pool to be allocated, the allocation keys used to allocate such costs to the Indian subsidiary, etc. are important aspects of such evaluation. Secondly, there are situations where the Indian subsidiaries have been observed to be making duplicate or double payments for the same set of services received. For example, payment of a technology royalty, as well as, payments for technical support services received could both be made to the AEs. A careful analysis is required to see that the two payments are not for the same set of services. This requires going into the components of the royalty and the IGS agreements/arrangements to identify overlapping elements. Thirdly, the mark-up charged on IGS costs by the associated enterprises is an important element of the transfer pricing audit. While the safe harbour provided for receipt of low value-added intragroup services builds in a 5% mark-up, the quantum of mark-up needs to be analyzed in detail in a case under an audit. There is no principle that a mark-up has to be charged invariably in every case. Rather, the charging of a mark-up should be guided by the market value of the services provided by the AEs. However, in most cases, it is difficult to evaluate the market value of such services as they are scarcely seen in unrelated transactions.

3.13.7 In view of the above facts, transfer pricing of intragroup services is considered a high risk area in India. India considers the payment for such intragroup services to be base-eroding in nature and, accordingly, attaches great importance to the transfer pricing of such payments. Further, even if an arm's length result is achieved in respect of such payments from India, an additional protection in the form of an overall ceiling on the amount of such payments may be required. This may be justified because even an arm's length payment might result in erosion of all the profits of the Indian entity or in enhancement of losses of the Indian entity, thereby, making the arm's length nature of such payments questionable. Thus, an overall ceiling on such payments in the form of a certain percentage of the sales or revenue of the Indian entity is being used in appropriate cases.

3.14 Financial Transactions

3.14.1. In India, the transfer pricing approach for inter-company loans and guarantees revolves around:

- examination of the loan agreement;
- a comparison of terms and conditions of loan agreements;
- the determination of credit ratings of lender and borrower;
- the identification of comparable third-party loan agreements; and

- suitable adjustments to the comparables to enhance comparability.

3.14.2 The Indian transfer pricing administration has come across cases of outbound loan transactions where the Indian parent has advanced to its associated enterprises in a foreign jurisdiction interest free loans or loans either at LIBOR (London Interbank Offered Rate) or EURIBOR (Euro Interbank Offered Rate). The main issue before the transfer pricing administration is the benchmarking of these loan transactions to arrive at the ALP of the rates of interest applicable on these loans.

3.14.3 A further issue in financial transactions is credit guarantee fees. With the increase in outbound investments, the Indian transfer pricing administration has come across cases of corporate guarantees extended by Indian parents to their associated enterprises abroad, where the Indian parent as guarantor agrees to pay the entire amount due on a loan instrument on default by the borrower. The guarantee helps an associated enterprise of the Indian parent to secure a loan from the bank. The Indian transfer pricing administration generally determines the ALP of such guarantees under the CUP Method. In most cases, guarantee rate quotes available from banking companies are taken as the benchmark rate to arrive at the ALP. The Transfer Pricing Officers sometimes also use the yield approach, wherein the benefit from the guarantee received by the guaranteed party in terms of lower interest rates is quantified and is used to benchmark the guarantee fee.

3.14.4 However, the Indian transfer pricing administration is facing a challenge due to the non-availability of specialized tools and of comparable prices for cases of complex inter-company loans and mergers and acquisitions that involve complex inter-company loan instruments as well as an implicit element of guarantee from the parent company in securing debt.

3.15 Dispute Resolution

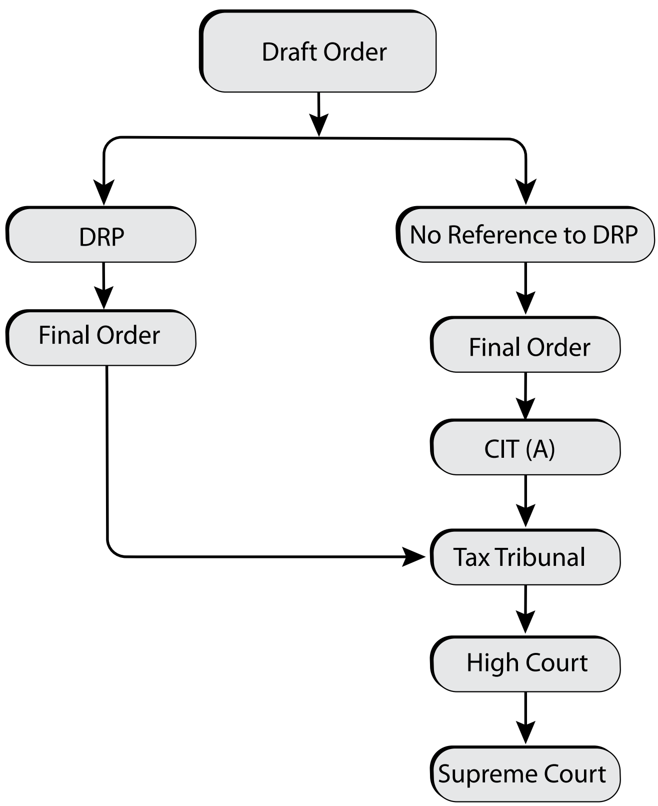
3.15.1 A comprehensive dispute resolution mechanism is available to taxpayers in India facing transfer pricing adjustments. As a part of the legal process in all cases, the Assessing Officer incorporates the order of the Transfer Pricing Officer in his own draft order and issues that to the taxpayer. The taxpayer has the option to file an objection against the draft order before the Dispute Resolution Panel which is a panel comprising three Commissioners of Income Tax. The Assessing Officer issues a final order in compliance with the Dispute Resolution Panel's directions. At present, the direction of the Panel is final for the tax administration and it cannot appeal further against the Panel's order. The taxpayer can challenge the direction of the Panel in appellate forums.

3.15.2 The sequence and availability of dispute resolution forums to the taxpayer in India is depicted in the flow chart below.

3.15.3 The Indian tax administration is aware of the problem of increasing transfer pricing disputes and the impact on the investment climate in India. Therefore, the Government of India has taken several steps to reduce litigation and the time needed to resolve tax disputes. Some of the steps taken in this direction are the following:

- risk-based selection of cases for transfer pricing audit instead of selecting all cases above a particular monetary limit of the value of international transactions for audit;
- introduction of the "range" concept in the Transfer Pricing Law along with the use of multiple-year data;
- use of the MAP provision in tax treaties for speedier resolution of pending cases;
- introduction of APA provisions in the law; and
- introduction of safe harbour provisions in the transfer pricing law

Tax Disputes Resolution Flow Chart (India)



3.16 Advance Pricing Agreements (APAs)

3.16.1 India introduced the APA provisions in its legislation in 2012. An APA is an agreement between the Central Board of Direct Taxes (CBDT) and any person, to determine, in advance, the ALP or specify the manner of determination of the ALP (or both), in relation to an international transaction. Once an APA has been entered into, the ALP of the international transaction will be determined in accordance with the terms of the APA for the period specified therein. An APA can be entered into for a maximum period of five years and can be renewed thereafter. The APA process is voluntary but once an APA is entered into, it becomes binding for both the taxpayer and the CBDT.

3.16.2 APAs can be unilateral, bilateral or multilateral. An applicant may request a particular type of APA while making the application. The scheme provides for an optional pre-filing consultation between the taxpayer and the APA team before filing a formal application. Such consultation can be on anonymous basis. The application is to be filed along with the specified fee. The Indian APA Scheme also provides for a rollback of the APA for a period of four years prior to the first year of the APA period. Therefore, the combined impact of an APA with rollback provisions is tax certainty for nine years. Rollback is not available for a year in which the Income Tax Appellate Tribunal (ITAT) has pronounced its decision on the issues proposed to be covered under the APA including the proposed APA Rollback. All the procedures relating to the APA Scheme have been prescribed in detail under the APA Scheme in the Income Tax Rules and certain issues have also been clarified by the CBDT through various Circulars and Frequently Asked Questions (FAQs).

3.16.3 Recently, the scope of APA provisions has been widened and APAs signed after 1 April 2020 can include agreement on profit attributable to a permanent establishment (PE) in India. This change is expected to reduce disputes and to bring certainty to non-residents doing business in India through a PE.

3.16.4 India accepts bilateral APA applications (besides transfer pricing MAP applications) regardless of the presence or otherwise of Paragraph 2 of Article 9, which provides for “corresponding adjustments”, in the applicable Double Taxation Avoidance Agreement (DTAA).

3.16.5 The Indian APA programme has been well-received by taxpayers and about 1,300 applications have been filed so far. More than 350 APAs have already been entered into by the CBDT. The APAs signed so far cover various sectors of the Indian economy including information technology, automobiles, telecommunications, steel, shipping, general trading, banking, pharmaceuticals, etc. It is expected that the robust APA programme in India would go a long way in reducing transfer pricing disputes and providing certainty to MNEs in such matters.

3.17 Safe Harbour

3.17.1 India introduced safe harbour provision in its legislation in 2009. Rules for administering the provision were subsequently notified.

Safe harbour provisions are intended to reduce the compliance burden for small taxpayers with regard to transfer pricing issues. Sectors/transactions covered under safe harbour rules are the following:

- software development;
- IT enabled services;
- knowledge process outsourcing services;
- outbound intragroup loans;
- corporate guarantees;
- contract R&D services in software;
- contract R&D Services in pharmaceuticals;
- manufacture and export of core auto components;
- manufacture and export of non-core auto components; and
- receipt of low value-adding intragroup services.

In 2020, the law was amended to expand the scope of safe harbour rules, to include determination of profit attributable to a PE in India.

3.18 The Base Erosion and Profit Shifting (BEPS) Final Reports on Actions 8 to 10 and 13

3.18.1 India has endorsed the Final Report of the BEPS project on Actions 8 to 10 dealing with various transfer pricing issues. Some of the issues addressed in the BEPS reports are in conformity with long standing views of the Indian transfer pricing administration. These include:

- the broad objective of aligning transfer pricing outcomes with value creation;
- giving importance to the Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions in respect of intangibles for remunerating the group entities of MNEs;

- testing of contractual allocation or contractual assumption of risk on the parameters of exercising control over risk and/or the financial capacity to bear the risk, and disregarding such contractual allocation or assumption of risk;
- harmonizing contracts with the conduct of parties;
- identifying and accurately delineating the transaction (i.e. identifying the "real deal") by analyzing the economically relevant characteristics;
- preventing the capital-rich but low-functioning entities ("cash box" entities) from contributing to base-erosion or profit-stripping; and
- non-recognition of commercially irrational transactions that cannot be seen between independent parties, etc.

3.18.2 Accordingly, the Indian tax administration is of the view that the guidance flowing from the Final Report of the BEPS project on Actions 8 to 10 should be utilized by both Transfer Pricing Officers and taxpayers in situations of ambiguity in interpretation of the law. However, India has not endorsed the guidance in the BEPS report pertaining to Low Value-Adding Intra Group Services (LVAIGS) under Action 10 and has not opted for the simplified approach.

3.18.3 India has also endorsed the recommendations contained in the BEPS Final Report on Action 13, which attempts to completely change the transfer pricing documentation standards. India has supported the three-tiered documentation regime comprising a Local File, a Master File and a Country-by-Country (CbC) Report and has already carried out legislative changes in its domestic law. Appropriate use of CbC Reports and maintenance of their confidentiality is ensured by the Indian tax administration through administrative instructions and guidance. India has been peer reviewed under guidelines laid down in the final report on Action 13 of the BEPS project without any major recommendations.

4 Mexico—Country Practices

4.1 Introduction

4.1.1 Mexico introduced transfer pricing rules in 1997 by including the arm's length principle in the Mexican Income Tax Law (MITL). Since fiscal year 2014, the transfer pricing rules are found in Articles 76-IX, 76-X, 76-XII, 110-X, 110-XI, 179, 180, 181 and 182; and regulate both cross-border and domestic intercompany transactions. The Transfer Pricing Guidelines for Multinational Companies and Tax Administrations as approved by the Council of the OECD are referred to as applicable in the MITL, for interpretation of the provisions in transfer pricing matters, to the extent that said guidelines are consistent with the provisions of the MITL and the treaties entered into by Mexico. The transfer pricing regulations are complemented by rules on their application by taxpayers regarding transfer pricing adjustments, interpretation criteria (e.g. comparability adjustments and interviews during APA processes) and undue fiscal practices (e.g. identification of unique and valuable contributions in comparability analysis).

4.1.2 In 2016, Article 76-A was incorporated in the MITL, mandating taxpayers to submit the following annual informative returns: (i) master file, (ii) local file and (iii) country-by-country report.

4.1.3 Tax audits in Mexico may be conducted through on-site inspection of taxpayers to review their accounting, goods and merchandise, or through desk reviews, in which the tax authorities may require that taxpayers submit their accounting records, data and other required documents and information at the offices of the tax authorities. In practice, most of the transfer pricing audits are conducted through desk reviews. In certain cases, Mexican taxpayers may receive a non-binding "invitation letter" sent by the Mexican Tax Authorities, raising questions as to specific risk indicators that could cause concerns to the risk assessment department, which has contributed in taxpayers solving tax issues before performing a tax audit or in rejecting preliminary candidates for further review.

4.2 Related Party Definition

4.2.1 In Mexico two or more individuals or legal entities are deemed as related parties when one of them has a direct or indirect participation in the management, control, or capital of the other, or when a person or a group of persons participate directly or indirectly in the management, control, or capital of such persons. There is no specific threshold for the entities to be considered related parties.

4.2.2 In addition, since 2002 members of joint ventures, as well as permanent establishments with regard to their central office or other permanent establishments, are considered related parties. This is in accordance with the provisions of Article 179 of the MITL.

4.3 Deemed Related Party Definition

4.3.1 It is assumed that any transaction performed with companies that are resident for tax purposes in preferential tax regimes (low or no income tax) will be considered to be carried out between related companies at values other than arm's length. In addition, it is established that the payments made to residents in such regimes are not deductible unless it can be proven that the price or consideration amount was at arm's length.

4.4 Specific Documentation Requirements

4.4.1 The law in force requires all taxpayers to prepare and keep documentation that proves that all the transactions carried out with related parties are conducted pursuant to the arm's length principle. The transfer pricing documentation must be prepared for each tax year and should have an evaluation per type of transaction and per related party.

4.4.2 In addition, certain taxpayers (e.g. large taxpayers) must also disclose information regarding the conclusions of the transfer pricing documentation as part of the appendixes of the statutory tax audit report, or the informative statutory report (ISSIF), along with the sign-off of the expert who prepared the referred documentation. The transfer pricing documentation must contain the following specific requirements:

(1) Name or firm name of the related company residing abroad, tax address and jurisdiction;

(2) Documentation that shows the direct or indirect participation among related parties;

(3) Information regarding assets, functions and risks per type of transaction;

(4) Information and documentation with the detail of each transaction performed with related parties and their amounts per type of transaction; and

(5) Transfer pricing method applied, as well as the documentation of comparable companies or transactions per type of transaction. An interquartile range of the results obtained from comparable transactions/companies must be used.

4.4.3 Taxpayers whose income for the immediately preceding tax year was under 13 million pesos for business activities, or 3 million for the provision of services, have no obligation to prepare and keep the documentation referred to in the law. This benefit does not apply in the case of transactions with companies residing in preferential tax regimes (low or no income tax), contractors or assignees under the terms of the Hydrocarbons Revenue Law, or in the case of having to prepare the transfer pricing informative return (Article 76-X of the MITL).

4.4.4 Such documentation should be recorded in account books, specifying that the transactions were performed with related parties residing abroad.

4.4.5 The MITL in force establishes that when using financial information to demonstrate that inter-company transactions were performed at arm's length, taxpayers must prepare such information in accordance with the accounting standard in order to calculate the income, cost, gross profit, net income, expenses and operating profit, as well as assets and liabilities.

4.4.6 Through an informative return (DIM Annex 9), taxpayers are also required to submit information regarding transactions with foreign-resident related parties. Said information includes among other data, a summary of the intercompany transactions results, elements of the economic analysis and the arm's length ranges. The non-compliance with the submission of this informative return results in penalties for the taxpayer.

4.4.7 In addition, companies that are required to file a statutory tax audit report (due on June 30) must also submit the following appendices with regard to transfer pricing:

(1) Type and amount of intragroup transactions by related party, transfer pricing method used, whether the intragroup transaction is at arm's length, and amount of the adjustment if so applied to comply with the arm's length principle;

(2) Taxpayer's business activity, ownership of intangible assets used or contributed, date on which the informative return was submitted and whether the taxpayer has supporting documentation

of the arm's length nature of intragroup transactions, advance pricing agreements (APAs) under negotiation, Tax ID of transfer pricing advisors, interest deemed to be dividends, pro rata expenses, financial derivative transactions with related parties, thin capitalization, corresponding adjustments, whether the taxpayer must submit the master file, local file or Country-by-Country report; and

(3) The external auditors of the Mexican taxpayer filing the statutory tax audit report will also have to complete a transfer pricing questionnaire confirming that all transactions were performed at arm's length and the documentation requirements that were met.

4.4.8 The documentation substantiating transfer pricing matters must be prepared every year no later than the date when the annual tax return is filed. In the case of an informative tax return, it must be filed not later than the date when the statutory tax report is filed.

4.4.9 The Mexican tax authorities conduct audits based on information provided by the taxpayer and other data, including information obtained from:

(1) Commercial databases; and

(2) Exchange of information mechanisms with treaty partners.

A key issue is that this information must be consistent and verifiable for purposes of the review.

4.4.10 Failing to keep documentary support will result in the external auditor's mentioning of such failure in his report and, in case of an audit, the authority may determine the method and comparable companies it deems appropriate in the application of the arm's length principle, and an adjustment to the income or deductions may be determined. This may result in a new taxable basis and consequently in a new tax charge including inflation, surcharges and penalties, in addition to the potential double taxation resulting from the payment made in the other country. The fine shall range from 55 to 75 per cent of the historical omitted tax (first and penultimate paragraphs of Article 76 of the Federal Tax Code), in the case of improper tax loss, the penalty shall range from 30 to 40 per cent of the difference between the filed tax loss and the loss actually incurred, both of these penalties can be reduced 50 per cent if the transfer pricing study requirement has been met (eight and penultimate paragraphs of Article 76 of the Federal Tax Code).

4.4.11 Article 76-A of the MITL establishes the general contents of the master file, local file and country-by-country report, and which taxpayers must file such annual informative returns. Submission of master file, local file and country-by-country report is regulated in Article 76-A and miscellaneous tax rules 3.9.11 through 3.9.17. Within this context, there is a penalty in case of failing to file the (i) master file, (ii) local file and (iii) country-by-country report, or submitting them incomplete, with mistakes, inconsistencies or differently from what is indicated in the tax provisions, the penalty shall range from MXN $154,800.00 to MXN $220,400.00, and is annually updated according to inflation.

4.5 Comparability

4.5.1 The following comparability factors are included in the MITL for purposes of the application of the arm's length principle:

(1) The characteristics of the goods and services;

(2) The functional analysis;

(3) The contractual terms;

(4) The economic circumstances; and

(5) The business strategies.

4.5.2 The MITL establishes the possibility of applying reasonable adjustments to eliminate differences between the comparable transactions or companies. Such adjustments must consider the aforementioned comparability factors. The application of this comparability adjustment follows the arm's length principle, and can be implemented, for instance, as a capital adjustment.

4.5.3 Public financial information for local comparables is limited in Mexico. Therefore, taxpayers may use adjusted foreign comparable data, as long as said adjustments are reasonable.

4.5.4 Under Article 69 of the Federal Tax Code (Código Fiscal de la Federación or FFC), the Mexican Tax Authority may use confidential information obtained from third parties to determine revenues and deductions of taxpayers that have not performed their transactions at arm's length.

4.5.5 Once the comparability factors are considered, the transfer pricing method must be applied which, under the facts and circumstances, provides reliable results. The six methods established in Article 180 of the MITL are basically the same methods included in the OECD Transfer Pricing Guidelines:

(1) Comparable Uncontrolled Price (CUP) Method;
(2) Resale Price Method (RPM);
(3) Cost Plus Method (CPM);
(4) Profit Split Method (PSM);
(5) Residual PSM; and
(6) Transactional Net Margin Method (TNMM).

4.5.6 In 2006, resulting from a recommendation from the OECD (as part of the Peer Review of the Mexican Transfer Pricing Legislation and Practices of March 2003), the MITL introduced a hierarchy for the application of transfer pricing methods. In particular, Article 180 of the MITL establishes that taxpayers may use another method only when the CUP Method as outlined in the OECD Transfer Pricing Guidelines is not appropriate to determine the arm's length nature of the tested transaction. The taxpayer must demonstrate that the method used is the most appropriate or most reliable pursuant to all available information, giving preference to the RPM or CPM over the PSM or TNMM.

4.5.7 To determine the price that should be used between independent parties, Article 180 of the MITL allows the use of a range of prices or profit margins resulting from the application of a method with two or more comparable transactions. Such range may be adjusted through statistical methods (specifically the interquartile range).

4.5.8 The MITL accepts multiple year data only for comparables, and provided that taxpayers must demonstrate that the business cycle or the commercial acceptance of the products cover more than one year. The MITL does not allow the use of multiple years if this is only applied as a statistical tool to mitigate changes and trends in the financial indicators of the comparables.

4.5.9 The MITL transfer pricing rules for inter-company financing focus on the characteristics to consider in applying proper comparability factors with uncontrolled transactions. These characteristics include the principal amount, payment period, guarantees, debtor's solvency and interest rate.

4.5.10 Payments made abroad for interest paid to related parties may be deemed as dividends if they arise from an unconditional promise of payment agreement involving the total or partial payment of credit received, of standby credit, or of a profit-related payment condition; or from the management of the business.

4.5.11 Thin capitalization rules are established in Article 28, Section XXVII of the MITL, which states that the interest paid to related parties will not be deductible in amounts exceeding the 3:1 ratio of liabilities to the equity of the company. The rule does not apply to entities that are part of the financial system (as defined in the MITL) and those taxpayers that assumed for the construction, operation or maintenance of productive infrastructure related to strategic areas of the country or electric power generation. Other exemptions and waivers regarding thin capitalization rules may apply. For example, taxpayers who obtain an APA for inter-company loan transactions are not subject to this limitation.

4.5.12 In the case of transactions related to the sale or purchase of stocks, the taxpayer must consider elements such as: (i) the equity value of the issuer's stockholders as of the transaction date; (ii) the present value of its profits or cash flows; or (iii) the last published market price of the stock.

4.6 Audit Procedure

4.6.1 In Mexico, taxpayers must allow inspections to verify tax compliance and provide all documentation requested by the tax authorities. If the tax authority considers that the taxpayer has not complied with its obligations adequately, the taxpayer must provide all evidence demonstrating such compliance.

4.6.2 The burden of proof resides with the taxpayer, who must prepare transfer pricing documentation to demonstrate that its intercompany transactions were performed at arm's length. If the tax authorities review this information and find that the taxpayer is not in compliance, the tax authorities are liable to determine arm's length prices, considering the information available or otherwise identified for such purposes. If the dispute goes to the tax court, the taxpayer and the tax authorities must present all evidence they deem appropriate to defend their respective positions.

4.6.3 Currently, different audit units of the Large Taxpayers Division of the Mexican Tax Administration conduct audits with a holistic approach, which includes transfer pricing along with other taxes such as VAT, withholding taxes, customs and other local tax provisions, with the coordination and advice of the Transfer Pricing unit.

4.6.4 One of the objectives of this audit programme is to focus revisions on the most recent tax years and, if possible, in real time, taking advantage of recently assembled information, experienced staff and resources to streamline the capacity of the tax administration to address tax issues and ensure that the business operations of the taxpayers are in compliance with the tax regime. The tax administration can also monitor the performance of the taxpayers in the post-audit stage and for more recent tax years it is much easier to understand and outline a value chain analysis of the business for a better resolution of the case.

4.6.5 Mexico has a cooperative compliance programme whereby based on principles of trust, transparency and mutual understanding the tax administration looks to improve voluntary compliance by taxpayers with their tax obligations. Applying an objective interpretative ("substance over form") criterion, which would facilitate and simplify the application of tax provisions, the tax administration aims to establish effective long-term, trustful relationships with taxpayers to identify risk areas and use its resources and capacity to find a successful solution. This programme is in line with international best practices.

4.6.6 Owing to the significant increase of audits (including transfer pricing) and the increase in tax controversies, and the long process for resolving disputes in tax courts, coupled with the high cost thereof, the Conclusive Agreement was created as an alternative for solving controversies during the audit process without the need of recurring to appeals or litigation. This mediation process can be considered as a domestic supplementary dispute mechanism that allows tax authorities and taxpayers alike to cope with the complexities of tax (including transfer pricing) disputes by providing the chance to solve the controversy at the audit stage.

4.6.7 The Conclusive Agreements are handled by the Tax Ombudsman Agency (Prodecon), which acts as an independent impartial official mediator between the taxpayer and the tax authorities.

4.6.8 The mediation begins with the request of the taxpayer which must contain the reasons for his dissent and the tax treatment that he believes should apply to the findings detected by the authority during the tax audit, accompanied of all the necessary documentation supporting his position. The filing of the Conclusive Agreement suspends legal deadlines, including the audit and collection procedures, which allows the parties to discuss and analyze the controversy in a detailed manner with no time constraints. However, the Conclusive Agreement is an effective and efficient mechanism when the taxpayer is aware of adjustments that must be performed to his tax position; for cases where the taxpayer is convinced that his tax position is correct it might represent an extended and inefficient use of resources.

4.6.9 The core of the mediation is the tax treatment that the tax administration is giving to the tax situation detected during an audit and can involve aspects related to the interpretation of the law, formal issues and/or assessment of evidence presented during the audit, as well as relieving associated penalties if the agreement is reached.

4.6.10 No tax debts are addressed during the mediation, since the procedure can only be initiated during the audit but not after the tax authority has issued a tax assessment. This encourages consensus since discussions between the parties take place before there is a final decision of the tax authority.

4.6.11 This procedure is optional for the taxpayer but it is mandatory for the tax authority to attend the mediation. However, as it is common in most alternative dispute resolution procedures, it is optional for the tax authority to finally accept or refuse the proposals to reach a solution to the dispute.

4.6.12 Meetings with the taxpayer and tax authorities can be set to discuss the specific tax controversy. The meetings are held in a neutral environment that encourages addressing technical issues through the exchange of points of view and documentation regarding tax law, accounting issues or tax specific situations, with the input and active participation of the representatives of Prodecon.

4.6.13 Once the Conclusive Agreement is signed, the tax effects agreed therein apply immediately and the tax audit is definitively closed. The parties are legally unable to challenge the result of a Conclusive Agreement by any domestic mean or modify the results of the agreement through negotiation in a MAP. Additionally, according to the Federal Tax Code, the Conclusive Agreement creates no legal precedent, which provides certainty to the tax authority that any agreed issues cannot be raised in a different or new tax controversy.

4.6.14 If no agreement is reached between the tax authority and the taxpayer the suspension of the audit concludes and all legal procedures are continued (i.e. by the issuance of a tax assessment). In this case, the taxpayer will still be able to file the corresponding legal defense, i.e. administrative appeal or tax litigation against the tax assessment.

4.7 Advance Pricing Agreements (APA) Procedures

4.7.1 Article 34-A of the Federal Tax Code enables taxpayers to submit unilateral, bilateral or multilateral APA requests. Unilateral APAs may cover the tax year of submission, the preceding tax year and the following three tax years. APAs may be valid for a longer period if an agreement is reached with the competent authority (authorities) of the Contacting State(s) under a Convention to which Mexico is party.

4.8 Maquila Export Companies

4.8.1 The Maquiladora Program started in the late 1960s as a direct response to the cancellation of the US Bracero Program that had allowed temporary Mexican migrant agricultural workers into the United States for seasonal employment. The Mexican and United States Governments agreed to the maquiladora programme whose immediate purpose was to provide employment in Mexico and generate economic activity in the manufacturing industry. It was not originally envisaged for taxation purposes, multilateral trade treaties or long-term foreign direct investment.

4.8.2 In 1989 the Mexican Government issued a decree to adapt and expand the maquiladora programme, with the intention of moving beyond simple job creation into a more meaningful economic development of the Mexican manufacturing and export generation base. The expansion programme was intended to develop a local supply chain for US manufacturers and to include a qualification programme (PITEX Program) for Mexican companies to produce and supply some of the inputs for the US companies (unlike maquiladoras that import all inputs).

4.8.3 A maquiladora is a Mexican subsidiary company, usually 100 per cent foreign-owned, whose primary role is assembly. Maquiladoras are defined in the Presidential Decree (Decrees for the Fostering and Operation of the Maquiladora Industry for Export) as assembly plants undertaking maquiladora activities under a permit issued by the Ministry of Economy.

4.8.4 Maquiladoras are usually structured as cost centres, with marginal profits. Their activities include the maintenance of assets and inventories provided by foreign residents for their transformation (production, sub-assembly and assembly) into semi-finished and finished goods destined for export (mainly for the United States market). Typically, foreign parent companies own inventories, equipment and machinery, provide the maquiladora with all the input, technology and know-how to carry out the manufacturing process, and allow the maquiladora the use of patents and technical assistance free of charge. Maquiladoras usually own or lease few assets, including a physical facility in Mexico; they hire and manage the labour pool required, and use capital free loaned by the parent company to transform inputs into products for export to the parent company or another related party. Many maquiladoras actually perform some additional functions for the parent company that must be identified and pay taxes apart from the maquiladora services. However, maquiladoras are generally treated as "contract" companies since it is considered that they perform functions requiring no valuable intangibles and very few routine intangibles.

4.8.5 Parties residing abroad may constitute a permanent establishment in Mexico arising from the legal or economic relations with Maquila export companies.

4.9 Current Maquila Provisions

4.9.1 Entities carrying out maquila operations will comply with the arm's length principle, and it will not be considered that the foreign residents for which the maquila operates will have a PE regarding the foreign assets being used if the maquiladoras determine their taxable profit according to "safe harbour" rules. Under this measure, the Maquila companies have to obtain a taxable profit that represents at least the larger of the values of:

(1) 6.9 per cent on the assets used in the Maquila activity, both its own and those of the party residing abroad; or

(2) 6.5 per cent on the costs and expenses incurred by the Maquila company.

4.9.2 This option has remained the same since the year 2000. For purposes of this option, the obligation to the Tax Administration Service (SAT) is to file an informative return stating that the taxable profit obtained represents at least the greater amount resulting from applying the 6.9 per cent or 6.5 per cent calculations as referred to above, corresponding to the safe harbour option.

4.9.3 These rules include several provisions for existing and newly organized maquiladoras with respect to the determination and valuation of the asset base and cost base (i.e. adjustments for inflation, amortization, inventory and currency conversion; exclusion for shelter activities, time frames, documentation requirements, conditions for changing options etc.).

4.9.4 Also, the entity resident in Mexico can submit an APA application to confirm compliance with the arm's length principle, and that foreign residents would not constitute a PE. The APA must be requested under the rules of Article 34-A of the Federal Tax Code.

4.9.5 Regarding the APA maquila programme, since the vast majority of cases dealt with US principals, in 2016 the Mexican tax authorities and the United States Internal Revenue Service (IRS) reached a technical agreement and established administrative measures so that U.S. taxpayers with maquiladora operations in Mexico will not be exposed to double taxation if they enter into a unilateral APA with Mexico, under terms agreed in advance between the U.S. and Mexican competent authorities.

4.9.6 The agreement between the competent authorities provides the Mexican Tax Authority the approach to be followed for qualifying taxpayers that have requested a unilateral APA. These taxpayers may apply a transfer pricing framework that the U.S. and Mexican competent authorities have agreed in advance will produce arm's length results.

4.10 Competent Authority Procedure

4.10.1 Determinations done by the tax authority of a jurisdiction regarding the compliance with the arm's length principle that represent a modification of revenues or deductions of a Mexican taxpayer may be performed solely by filing an amended tax return, providing that the SAT has accepted such adjustment, validated through a competent authority procedure under the tax treaty in place.

4.10.2 The tax authorities may totally or partially condone the surcharges resulting from an adjustment to prices or to consideration amounts in the case of transactions between related parties, provided that said condoning arises from an agreement with a competent authority, based on reciprocity, between the competent authorities of Mexico and those of a country with which Mexico has entered into a double tax convention, and provided that said authorities have refunded the corresponding tax without the payment of any amounts corresponding to interest.

4.11 Effective Implementation of the Arm's Length Standard

4.11.1 The main pillars of an effective implementation of the arm's length standard are comprehensive legislation, trained and adequate personnel, control procedures and a robust, systematic and precise risk assessment system.

4.11.2 Mexico recognizes that a well-founded risk assessment system is the correct starting point of an effective tax audit cycle, and in this regard a series of tax structures and arrangements have been identified by the Mexican Tax Administration and tackled by implementing specific audit programmes. This relates to the causes and effects of eroding structures, which from a transfer pricing perspective have an impact on operating results, net results and tax results of non-reported inter-company income, involving base eroding payments (including those settled with low-tax jurisdictions or with no economic sense, such as royalties, interests, intra-group services, among others) and business restructurings (assets and risk reallocations).

4.11.3 It has been recurrently noted by Mexican tax officials that intragroup service transactions are a risk area, and in 1981 the Mexican Income Tax Law was reformed to include a limitation of the deduction of prorated expenses. Nonetheless in 2014, the Mexican Supreme Court ruled that the limitation of the deduction of prorated expenses is neither absolute nor unrestricted, thus the deduction may be permitted if certain conditions are fulfilled, namely that the service transaction has been rendered, that it provides a benefit to the recipient and that it conforms to the arm's length principle.

4.11.4 Information asymmetry is a critical issue in effectively documenting an intragroup service transaction so it is crucial that taxpayers provide appropriate information on the service rendered, the service provider entity (even if it is a foreign entity), and the benefit test. It would also be useful to make a general assessment of the financial status of the service recipient entity, which must have the financial capacity to bear the expense; and it has been important to clarify to taxpayers in Mexico that in the absence of the appropriate information that demonstrates an intragroup service transaction the expenses can be non-deductible under the Income Tax Law.

4.11.5 Royalties paid by a taxpayer to nonresident related parties for the temporary use of intangible assets are likely to be challenged when such royalties are from a Mexican source and were previously owned by such taxpayer or any related party thereof residing in Mexico, when the transfer of the intangible assets was made without receiving any consideration or at a non-arm's length price.

4.11.6 The SAT has challenged the fact pattern where there are advertising and marketing expenses incurred by Mexican subsidiaries along with royalties paid to their related parties abroad for marketing intangibles, since the legitimate owners of the intangibles surplus are the ones creating them. These are mostly the entities in charge of the development of brand awareness, brand positioning, and brand prestige adding value to the business cycle.

4.11.7 Mexican subsidiaries should be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles.

4.11.8 Two of the key components of the aforementioned transactions are the economic valuation of the intangible assets and the amount of the royalty payments arising from the use of such assets. Both elements should be analyzed under the tax regulations on transfer pricing in force since 1997.

4.11.9 In Mexico, as in many countries, taxpayers tend to over-utilize net margin TP methods to support the Mexican taxpayer's financial results (regardless of a careful review in establishing the tested party), collecting external comparables operating in the same industry from commercial databases, mostly from developed countries such as United States and Canada, since public data from local comparables is scarce due to the low market capitalization in Mexico. Since in most industries the macroeconomic conditions between Mexico and developed countries such as the United States and Canada differ, it is necessary to perform comparability adjustments to the financial results of the comparables.

4.11.10 The application of a comparability adjustment follows the arm's length principle, and this can be implemented as a capital adjustment taking into account the inherent differences between the sovereign bond yields of the two countries — the country of residence of the tested party and the country of residence of the comparable — and applying it as a factor in the invested capital or operating assets of the companies. Even though a country risk adjustment would generally improve the comparability of the companies in this situation, there can be specific industrial differences among countries which must be evaluated independently. Another separate comparability adjustment may come from local saving advantages.

4.11.11 An aggressive tax planning structure found in Mexico relates to full manufacturing companies performing all productive processes from purchase of raw materials, manufacturing the products, product development and incorporation of intangibles, searching for clients, selling the finished products to the clients, and assuming all related risks in the Mexican market; and suddenly the manufacturing activities turn into maquila services and presumably acts as a limited risk entity only receiving compensation through a mark-up over salaries, and a minimal commission for the sales to the retailers, despite having the same functions as before the reorganization.

4.11.12 These reorganizations are being challenged following the 2014 tax reform under which maquila companies must export all of the products they produce, and if the products are found to be sold in Mexico, the value chain, even if fragmented, would be assessed and taxed in its entirety in Mexico, including the manufacturing and distribution portions of the business performed in Mexico.

4.12 Recent Developments

4.12.1 The SAT is committed to implementing the Base Erosion and Profit Shifting (BEPS) initiatives. Within this context, the 2020 tax reform (in effect for fiscal year 2021) establishes the implementation of Action 4 (Limitation on Interest Deductions; establishing a limit of 30% of EBITDA, contained in Article 28 —XXXII of the MITL).

4.12.2 In addition, the above mentioned tax reform also implemented

Action 12 (Mandatory Disclosure Rules) through Articles 197–202 of the Federal Tax Code. Regarding Mandatory Disclosure Rules, the transfer pricing-related schemes that must be disclosed contemplate the following:

- Transmission of Hard to Value Intangibles;
- Business restructurings;
- Non-remunerated services or functions, as well as non-compensated transmission of goods and rights;
- Transactions for which there are no reliable comparables; and
- Application of foreign safe harbours.

5 South Africa—Country Practices

5.1 Introduction

5.1.1 Transfer pricing remains a strategic focus area for the South African Revenue Service (SARS), forming an integral part of SARS' compliance programme. As South Africa has gone through low economic growth in recent years and the global COVID 19 pandemic, the focus remains on identifying and challenging structures that lead to profit shifting and mispricing.

5.2 South African Transfer Pricing Landscape

5.2.1 The fundamental principle underpinning South African transfer pricing legislation, since inception, has been the arm's length principle as set out in Article 9 of both the UN Model Double Taxation Convention between Developed and Developing Countries and the OECD Model Tax Convention on Income and on Capital. This UN Practical Manual on Transfer Pricing reinforces this principle for Developing Countries and the OECD Transfer Pricing Guidelines.

5.2.2 South Africa's transfer pricing legislation is set out in Section 31 of Income Tax Act (Act No. 58 of 1962) (Income Tax Act), and came into effect on 1 July 1995. This was followed by Practice Note 7 dealing with transfer pricing (published on 6 August 1999) which serves to provide taxpayers with guidance on how SARS interprets the legislation.

5.2.3 In 2012, South Africa introduced the Tax Administration Act (Act No. 28 of 2011) (Tax Administration Act), which was to incorporate in a single piece of legislation certain generic tax administrative provisions, which were duplicated in different tax Acts. The Tax Administration Act is therefore applicable for compliance and administration of the transfer pricing legislation.

5.2.4 Important legislative amendments to both the Income Tax Act and the Tax Administration Act are highlighted in 5.4 below.

5.3 Recent Developments

Domestic

5.3.1 South Africa's Minister of Finance announced in February 2013 that the government would initiate a tax review to assess South Africa's tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability. A committee known as the "Davis Tax Committee" (DTC) was inaugurated and the Committee's Terms of Reference were announced in July 2015.

5.3.2 The OECD/G20 BEPS Project was launched in September 2013 with South Africa participating as an equal partner. As a result, the DTC set up a BEPS Sub-Committee to address its concerns around base erosion and profit shifting and to formulate the DTC's position in this regard. The DTC consulted with various stakeholders from business representatives, trade unions, civil society organizations, tax practitioners, SARS, National Treasury, the South African Reserve Bank, members of international bodies and academics, in releasing its "BEPS First Interim Report" for public comment by 31 March 2015. The final report was released in July 2016.

5.3.3 After review and evaluation, SARS has implemented certain of the DTC's recommendations relating to documentation, tax returns and building capacity in the transfer pricing division.

International

5.3.4 South Africa is not a member of the OECD but has the status of being a participant in the Committee on Fiscal Affairs and as an associate to the Base Erosion Profit Shifting (BEPS) project for the G20 in 2013. South Africa is thus an associate to the Inclusive Framework on BEPS from 2016. However, as part of the OECD/G20 BEPS Project, South Africa was an associate on equal footing alongside OECD member countries. The BEPS Project raised areas of improvement for South Africa, especially in relation to asymmetry of information, resulting in legislative and administrative changes.

5.4 Legislative and Administrative Framework

<u>Section 31 of the Income Tax Act</u>

General

5.4.1 The most significant legislative amendments since the inception of the transfer pricing legislation came into effect in 2012, *inter alia* consolidating the transfer pricing and thin capitalization provisions.

5.4.2 The ambit of Section 31 was widened to consider any transaction, operation, scheme, agreement or understanding that was entered into between a South African resident and an offshore-connected person (including permanent establishments and controlled foreign companies) for the benefit of a South African resident.

5.4.3 With the overhaul of the transfer pricing legislation, taxpayers bear the onus of demonstrating that the transactions entered into are at arm's length.

Connected Persons

5.4.4 One of the requirements for the transfer pricing provisions to apply, is a connection between the entities. Section 1 of the Income Tax Act defines this connection as a "connected person".

5.4.5 With effect from 1 January 2022, the connection requirement is further widened by the inclusion of associated enterprises, defined as an associated enterprise as contemplated in Article 9 of the Model Tax Convention on Income and on Capital of the OECD.

Secondary Adjustments

5.4.6 From 2015, the secondary adjustment provision was amended and the difference between taxable income on an arm's length basis and taxable income on the non-arm's length basis is deemed to be a distribution of an asset *in specie* in the case of a company and a donation in the case of any other type of taxpayer.

5.4.7 No treaty relief is available for dividends tax as a deemed dividend *in specie* for transfer pricing purposes has been specifically excluded from the definition of dividend in Section 1 of the Income Tax Act.

5.4.8 As the taxpayer bears the onus to demonstrate that it transacted at arm's length, voluntary adjustments made after a tax return has been filed will also incur the secondary adjustment.

Thin Capitalization and Financial Transactions

5.4.9 As a result of the legislative changes to the transfer pricing provisions in 2012, the thin capitalization provisions changed from a safe harbour of a 3:1 debt to equity ratio to an arm's length test.

5.4.10 The financial transactions paper issued by the OECD in February 2020 furthermore guides SARS on financial transactions.

5.4.11 Section 23M of the Income Tax Act provides a limitation on the deduction of excessive interest, which is also applicable to cross border financial assistance transactions between certain connected persons.

5.4.12 National Treasury is currently undertaking further work on the limitation of excessive debt and has published a paper titled "*Reviewing the tax treatment of excessive debt financing, interest deductions and other financing payments*" for public consultation on 26 February 2020. The deadline for submission of public comments on the draft paper is 30 September 2020.

Transactions to which the Transfer Pricing Provisions are Not Applicable

5.4.13 In order to eliminate the potential for double taxation described above, it was legislated that the transfer pricing provisions would not apply to certain cross-border financial assistance transactions (e.g. loans) and certain cross-border uses of intellectual property. More specifically, transfer pricing will not apply to holders (i.e. creditors) of a loan or holders of intellectual property if:

- ➢ The holder is a South African company;
- ➢ The obligor is a controlled foreign company (CFC) in relation to the South African holder and 10 per cent of the equity shares and voting rights in the obligor is directly owned by that holder (whether alone or together with any other company forming part of the same group of companies as the holder);
- ➢ The CFC has a foreign business establishment; and
- ➢ The CFC is taxed at a comparable rate (an aggregate effective rate of 67.5 per cent of the South African rate that would otherwise be imposed). For purposes of this 67.5 per cent threshold, foreign taxes on income imposed by all foreign spheres of government (national, provincial and local) must be taken into account. The calculation of the aggregate effective rate also takes into account all income tax treaties, rebates, credits or other rights of recovery. Lastly, the rate is calculated after disregarding carryover losses as well as group losses.

5.4.14 With regard to the provision of financial assistance and licensing of intellectual property to a controlled foreign company, the Explanatory Memorandum[157] explains the reason for the introduction of the provisions

[157] Republic of South Africa (2012). *Explanatory Memorandum on the*

mentioned above: "*South African companies often make interest-free loans to controlled foreign subsidiaries for non-tax reasons. These soft-loans often operate as an implicit form of share capital (i.e. lacking interest and fixed dates of repayment). The purpose of these loans is mainly to allow for the seamless withdrawal of funds for foreign company law and to alleviate certain adverse impacts of foreign exchange controls. As such, these soft loans are an important method of indirectly funding offshore start-up operations. South African companies may also provide yield-free licenses (and other forms of yield-free intellectual property) to controlled foreign subsidiaries for similar non-tax reasons. The lack of yield for these instruments unfortunately has undesirable side-effects for tax purposes. The South African holder may be subject to transfer pricing concerns, thereby being subject to tax based on a higher notional yield. On the other hand, the foreign company obligor will often be allowed a foreign deduction only for actual cross-border payments to the South African company (as opposed to a foreign deduction for the higher notional payments). The net result is a potential de facto double taxation; a result that reduces the international competitiveness of South African multinationals.*".

5.4.15 Furthermore, where a South African resident company (or any company that forms part of the same group of companies as the South African resident company) grants financial assistance to a foreign company in which the South African resident (whether alone or together with any other company that forms part of the same group of companies as the South African resident company) constitutes a debt owed by that foreign company to that resident company (or any company that forms part of the same group of companies as the South African resident company), the foreign company:

- is not obliged to redeem that debt in full within 30 years from the date the debt is incurred;
- the redemption of the debt in full by the foreign company is conditional upon the market value of the assets of the foreign company not being less than its market value of the liabilities; and
- no interest accrued during the year of assessment.

Tax Administration Act

Income Tax Returns

5.4.16 Substantial improvements to increase disclosure requirements of transfer pricing and other BEPS related transactions have been made to the

Taxation Amendment Bill, 2012. South Africa.Para. 5.8. Available from https://www.sars.gov.za/wp-content/uploads/Legal/ExplMemo/LAPD-LPrep-EM-2012-01-Explanatory-Memorandum-Taxation-Laws-Amendment-Bill-2012.pdf.

corporate income tax return.

Documentation

5.4.17 Prior to 2016, South Africa did not have specific statutory transfer pricing documentation requirements. Following the BEPS project and the recommendations made by the DTC, the specific statutory documentation retention requirements set out below were introduced by public notice[158] in terms of Section 29 of the Tax Administration Act in 2016 for transfer pricing. The extent of the documentation to be kept is tiered according to the reasonably expected value of the transaction:

- Records, books of account or documents in respect of the structure and business operations; and
- Records, books of account or documents to be kept in respect of the affected transactions.

5.4.18 Country-by-Country reporting, master file and local file requirements for large multinational enterprises were also introduced by public notice[159] in terms of Section 25 of the Tax Administration Act in 2016.

Access to Information

5.4.19 One of the key challenges in any transfer pricing analysis is access to information. This is a widespread problem not unique to South Africa and indeed was also acknowledged in the BEPS project. Over the years SARS had been challenged on a number of fronts regarding its information requests including, *inter alia*:

- SARS' right to certain categories of information. Taxpayers have argued for the non-submission of information on the basis that such information is commercially sensitive, irrelevant and out of scope, not accessible, or legally privileged;
- taxpayers requesting numerous extensions of time within which

[158] South African Revenue Service (2016). *Public Notice: Duty to Keep the Records, Books of Account or Documents in Terms of Section 29 of the Tax Administration Act, 2011.* Available from, https://www.sars.gov.za/wp-content/uploads/Legal/SecLegis/LAPD-LSec-TAdm-PN-2016-05-Notice-1334-GG-40375-28-October-2016.pdf

[159] Available from https://www.oecd-ilibrary.org/sites/11a9e935-en/index.html?itemId=/content/component/11a9e935-en and https://www.gov.za/speeches/revenue-service-automatic-exchange-tax-information-revenue-authorities-27-feb-2017-0000

to comply with a SARS information request to the point that the statute of limitation runs out for SARS or that it becomes almost impossible for SARS to review such information before the statute of limitations runs out; and

- taxpayers have challenged SARS's powers to interview persons and personnel that may have information relevant to the transaction under audit.

5.4.20 To address the above information related challenges, the following legislative amendments have been effected to the Tax Administration Act:

5.4.21 The overarching provisions of Section 46 clarifying the information gathering powers of SARS to be that SARS can request information that is relevant or foreseeably relevant. There is no onus on SARS to explain or justify information requests. However, it was acknowledged that legal professional privilege was an exceptional situation. For this reason, Section 42A of the Tax Administration Act was introduced clarifying the requirements to be met by taxpayers failing to submit relevant information to SARS on the basis of legal professional privilege and the process to be followed to resolve the issue;

5.4.22 Amendment to Section 46 with respect to access to foreign based information and to ensure that, where a matter progresses to dispute resolution, taxpayers are held to any assertions that they were unable to access information located offshore. Where a taxpayer makes such an assertion, the taxpayer may, under certain circumstances, be prohibited from submitting such information at a later stage;

5.4.23 Amendment to Section 47 clarifying persons who may be interviewed or called upon to provide information on a taxpayer/company/entity under audit. Important to this amendment is the existing requirement in terms of Section 49 of the Tax Administration Act, which allows SARS to request such persons to be interviewed under oath or solemn declaration.

Statute of Limitation

5.4.24 There is a general three-year statute of limitation for assessments by SARS to execute and conclude any audit. The statute of limitations may be further extended in terms of Section 99 of the Tax Administration Act:

- The statute of limitation may be extended by agreement between SARS and the taxpayer;
- SARS may extend the statute of limitations by prior notice by

a period approximate to the delay of the taxpayer in providing relevant material within the required time period; and

- This statute of limitations period can also be extended by SARS, with prior notice to the taxpayer, for a period of three years where an audit or investigation relate to transfer pricing, the application of substance over form, the general anti-avoidance rule or the taxation of hybrid entities or hybrid instruments.

5.5 Year-End Adjustments

5.5.1 There appears to be an increasing tendency for parent companies of South African subsidiaries to shift profits via a year-end adjustment to either the cost of goods imported by the South African subsidiary or directly to the operating margin, to bring the South African subsidiary in line with "comparable companies". What occurs is usually a global policy change by the parent company aimed at limiting the return of its subsidiaries (including those based in South Africa) to a guaranteed return (determined by way of a comparable search). The change in policy is often followed by an introduction of year-end transfer pricing adjustments to ensure that South African entities achieve the often low targeted net margin while the residual profit is returned to the parent or holding company.

5.5.2 There is little or no regard for the drivers of higher profits attained in South Africa when comparing them to comparable companies in foreign markets (given there are no local comparables for South Africa) or consideration for the actual functional and risk profile of the South African subsidiary. South African subsidiaries of multinational companies are frequently classified as limited risk distributors or limited risk manufacturers when in actual fact they assume much more than just limited risk.

5.5.3 Further, there are many instances where unique dynamics exist within the South African market that enable South African subsidiaries to realize higher profits than their connected party counterparts in other parts of the world or than is evidenced by comparable data obtained from foreign databases. The increased participation and spending power of the middle class segment in the economy also offers a new market opportunity for certain industries.

5.5.4 Year-end adjustments that result in an under declaration of income tax, will incur the secondary adjustment, penalties and interest. Furthermore, as there may have been under declaration of customs duty and import VAT, additional customs duties and VAT may be payable.

5.6 Comparability

5.6.1 The main challenge that South Africa has in determining arm's length profits has been the lack of domestic comparables. It is thus accepted that the most reliable comparables will suffice. The problem in South Africa is that this compromise is exacerbated even further given that databases contain extremely limited South African specific, or for that matter, Africa specific, comparable data. As a result, both the tax administration and taxpayers often rely on European databases to establish arm's length levels of profitability.

5.6.2 Instituting comparability adjustments to account for geographical differences (for example, market, economic and political differences) in order to improve the degree of reliability of the comparable data, is often extremely complex and can in some instances have the reverse effect, i.e. where the comparable data is no longer comparable.

5.6.3 In practice, SARS has attempted to make comparability adjustments, for example, country risk adjustments based on publicly available country risk ratings and government bond rates (sometimes referred to as the risk free rate). However, these have been applied with caution and in specific circumstances.

5.6.4 Whilst South Africa may be worse off than some countries in having extremely limited domestic comparable data, many other countries are likely to be in a similar position. As multinationals become more and more complex in their business models, and as more widespread industry consolidation is achieved, finding comparable data and achieving reliability may not be South Africa's problem alone. It is perhaps already true that for certain types of large scale manufacturing and distribution activities, for example in the automotive industry there is no independent comparable data available anywhere.

5.6.5 It is for this reason, amongst others, that SARS favours a more holistic approach to establishing whether or not the arm's length principle has been complied with. By seeking to understand the business model of taxpayers across the whole value chain, gaining an in-depth understanding of the commercial sensibilities and rationalities governing intragroup transactions and agreements, it is evident that SARS does not look to comparable data alone or in isolation from other relevant economic factors in determining whether or not the appropriate or arm's length level of profit has been achieved.

5.7 Intangibles

5.7.1 As intangibles are often "unique" in nature they raise unique transfer pricing challenges for both multinationals and tax administrations. Disputes that arise in South Africa relate to the existence of local marketing intangibles, issues of economic versus legal ownership and the valuation of intangibles. The revised guidance in Chapter 6 of the OECD Transfer Pricing Guidelines as a result of the BEPS Project was welcome and provides helpful guidance for developing countries.

5.7.2 In the South African experience, the sale of South African developed intangibles presents a somewhat exceptional situation compared to the rest of the world, as exchange control regulations prohibit the export of South Africa developed intangibles, in the absence of approval by the Financial Surveillance Department of the South African Reserve Bank. Once the worldwide (excluding South Africa) intangible property is sold to an offshore connected party, usually in a low tax jurisdiction, the connected party becomes the legal owner of the intangible property for the rest of the world, excluding South Africa. This connected party then licences out the intangible property worldwide (excluding South Africa) earning royalties. In addition, terms and conditions of the original sale may dictate that the South African entity will continue to perform certain functions toward the enhancement and further development of the intangible property for which it earns a cost plus return. The connected party, that is now the legal owner, in essence merely carries out activities relating to registration and maintenance of the intangible property and earns an intangible connected return (in the form of royalties). Furthermore, if such intangible property were ever sold outside of the group, the South African entity would have no participation in any profits that may be realized.

5.7.3 South Africa has enacted anti-avoidance provisions to limit BEPS in relation to IP payments. This is in the form of Section 23I of the Income Tax Act that denies a general deduction in respect of fees paid for the use of IP where the IP was originally developed in SA and subsequently migrated to a foreign jurisdiction for licensing back to SA.

5.8 Intragroup Services

5.8.1 As a result of an increase in globalization, in order to achieve economies of scale and optimize efficiencies, it is becoming commonplace for multinationals to centralize the provision of certain services in a single entity, generally in a tax advantaged jurisdiction.

5.8.2 South Africa has consistently stated that it will not be applying the simplified approach to low value-adding services, as outlined in the final BEPS report.

5.8.3 In essence, Chapter 7 of the OECD Transfer Pricing Guidelines set out the approach that in establishing the arm's length nature of intragroup services, the test is twofold. Firstly, it must be determined if a service has been rendered and secondly it must be determined if the charge for such service is arm's length (paragraph 7.5 of the OECD Transfer Pricing Guidelines). As relates to the first part of the test, the approach followed is to determine if the services:

- provide the recipient with economic and commercial benefit (now called the "Benefits Test" in the revision to Chapter 7);
- are not services that the recipient is already performing for itself (duplicate service test); and
- are not shareholder services.

5.8.4 As regards the second part of the test, the audit approach seeks to confirm the following:

- that the cost base is appropriate to the services provided;
- that the mark-up is arm's length; and
- that the allocation keys applied are commensurate to the services provided.

5.8.5 In particular, paragraph 7.29 of the OECD Transfer Pricing Guidelines states that in determining the arm's length price for intragroup services, the matter should be considered from the perspective of the service provider and the recipient. Relevant considerations include the value of the service to the recipient as well as the costs to the service provider.

5.8.6 SARS is currently taking a pragmatic but firm approach to evaluating payments for intragroup services and where clear commercial justification or reasonableness for those payments is lacking, the payments are disallowed.

5.9 Dispute Resolution

5.9.1 Once an assessment has been raised, the taxpayer may lodge an objection against such assessment.

5.9.2 Currently the Alternative Dispute Resolution ("ADR") mechanism allows for resolving a dispute other than through litigation. The ADR process is governed by the rules promulgated under Section 103 of the Tax Administration Act.

5.9.3 SARS and the taxpayer can initiate the ADR mechanism once the taxpayer has lodged an Appeal against the disallowance of an objection against an assessment. SARS, however makes the final decision as to whether a matter is suitable for ADR.

5.9.4 A facilitator, who will endeavour to resolve the dispute, facilitates the ADR meeting between the taxpayer and SARS. The taxpayer and SARS may agree in certain instances not to use a facilitator, in which case the taxpayer and SARS will endeavour to resolve the dispute.

5.9.5 If a matter is not resolved during ADR, the litigation route may be followed.

5.10 Exchange of Information

5.10.1 The majority of South Africa's Double Taxation Agreements ("DTA") contain an Article dealing with the exchange of information.

5.10.2 In addition, South Africa has entered into the following categories of Exchange of Information Conventions/Agreements:[160]

- USA FATCA Intergovernmental Agreement—The USA FATCA Intergovernmental Agreement is an agreement between the governments (tax administrations) of the United States of America and the Republic of South Africa to exchange information automatically under the provisions of the double taxation agreement between these countries. The Standard for Automatic Exchange of Financial Account Information (the Standard or the CRS) is a standardized automatic exchange model, which builds on the FATCA IGA to maximize efficiency and minimize costs, except that the ambit is now extended to all foreign held accounts and not only those of US citizens. South Africa is also one of the early adopters of the CRS;
- Multilateral Mutual Administrative Assistance ("MAA") Conventions / Agreements—agreements between the governments (tax administrations) of two or more jurisdictions to enable them to exchange tax information on request, spontaneously or automatically, as well as to provide assistance in the collection of taxes;

[160] https://www.sars.gov.za/legal-counsel/international-treaties-agreements/exchange-of-information-agreements/

- Bilateral Tax Information Exchange Agreements ("TIEAs")—agreements between the governments (tax administrations) of two jurisdictions to enable them to exchange tax information upon request;
- Double Taxation Agreements ("DTA")—agreements between two tax administrations to two countries to enable the administrations to eliminate double taxation;
- Bilateral Common Reporting Standard Competent Authority Agreements ("CRS CAAs") / MoUs—bilateral agreements between the Competent Authorities of two jurisdictions to enable them to exchange information under the CRS; and
- Bilateral Country-by-Country Competent Authority Agreements (CbC CAAs) / MoUs—bilateral agreements between the Competent Authorities of two jurisdictions to enable them to exchange CbC reports.

5.11 Mutual Agreement Procedure (MAP)[161]

5.11.1 Different positions taken by two or more administrations, on what constitutes arm's length conditions for a transaction between associated enterprises, can lead to economic double taxation. Article 25 OECD Model Tax Convention enables competent authorities to consult with each other with the view to resolve taxation not in accordance with the Convention. This also applies in the context of transfer pricing problems relating to economic double taxation. South Africa provides access to MAP in transfer pricing cases in particular. DTA provisions such as Article 9(2) of the OECD Model Tax Convention or, in the absence of Article 9(2) of the OECD Model Tax Convention, provisions of domestic law enable contracting jurisdictions to provide for a corresponding adjustment with the aim of avoiding double taxation.

5.11.2 A MAP case is a transfer pricing MAP case where the taxpayer's MAP request relates to:

- the attribution of profits to a permanent establishment (Article 7 of the OECD Model Tax Convention)[162], including the

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[161] South Africa Revenue Service (2020). *Guide on Mutual Agreement Procedures, Issue 3.* para. 2.1.3. Available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G24-Guide-on-Mutual-Agreement-Procedures.pdf

[162] South Africa has not adopted the Authorized OECD Approach (AOA) and has raised a reservation in this regard.

determination of whether a permanent establishment exist in a contracting jurisdiction (Article 5 of the OECD Model Tax Convention); or

- the determination of profits between associated enterprises (paragraph 1 of Article 9 of the Model Tax Convention) and the corresponding adjustments to be made in pursuance of paragraph 2 Article 9 of the OECD Model Tax Convention and assessing whether they are well founded and for determining the amount.

5.11.3 Under normal circumstances, secondary adjustments (discussed at paragraphs 4.6 to 4.8 above) are reversed if the primary adjustment is reversed or, if the taxpayer repatriates funds from the non-resident equivalent to the amount of the transfer pricing adjustment. In these two instances, relief from the secondary adjustment should be a consequence of the MAP settlement.

5.11.4 A transfer pricing MAP case does not include a request for an APA.

5.11.5 In determining if taxation of relevant transactions satisfies the arm's length principle, and thus result in taxation in accordance with the provisions of a DTA, South Africa is guided by the OECD Transfer Pricing Guidelines and this UN Practical Manual on Transfer Pricing for Developing Countries.

5.11.6 A person can pursue the MAP and domestic legal remedies (See 5.9 on Dispute Resolution above) simultaneously. SARS may concurrently consider a case presented to the competent authority for MAP and the objection lodged by the taxpayer under domestic tax provisions against the assessment. Depending on the circumstances, the competent authorities may defer the MAP until a decision has been reached on the objection or if a taxpayer has requested a settlement.

5.11.7 MAP does not automatically suspend the payment of taxes. Therefore, it is advisable that taxpayers lodge an objection or appeal concurrently with the MAP process.

5.11.8 South Africa has not committed to MAP arbitration under BEPS Action 14 and the majority of South Africa's DTAs do not contain this provision. A MAP arbitration provision is included in the DTAs with Canada (1997), Netherlands (2008) and Switzerland (2009).

5.12 Advance Pricing Agreements (APAs)

5.12.1 South Africa currently does not have an APA programme due to the scarcity of resources. However, The South African Revenue Service Strategic Plan 2020/21 – 2024/25 states as its "Strategic objective 1: Provide clarity and certainty for taxpayers and traders of their obligations" that "… *Taxpayers and traders proactively receive clarity guidance, and where required, have easily accessible additional customized support. Certain segments of taxpayers and traders may also access leverage products such as advance pricing agreements, advance rulings (inclusive of VAT rulings and Binding General Rulings) and cooperative compliance programmes.*"

5.13 Conclusion

5.13.1 Owing to the rapid evolution in the international tax landscape and the change in the mode of doing business by South African multinationals, South Africa continues to explore new ways of protecting its tax base through participation in international fora (such as the OECD, ATAF and the UN).

5.13.2 This evolution has brought about substantial changes to South Africa's transfer pricing legislation through incorporation of some of the international best practices and international guidance that has allowed South Africa to be on par with international standards.

6 Kenya—Country Practices

Kenya's Transfer Pricing Experience

6.1 Introduction

6.1.1 Transfer pricing refers to the setting of prices for transactions occurring between associated entities. It is a common practice with globalization and growth in international trade. Transfer pricing manipulation increases the risk of capital flight and shifting of profits by multinational enterprises. Kenya has put up measures to protect her tax base from transfer pricing risks posed by cross-border transactions between related entities, through enactment and enhancement of tax legislation and administration.

6.2 Transfer Pricing Legislation in Kenya

6.2.1 Section 18(3) of Income Tax Act, Chapter 470, Laws of Kenya, is the basic legislation governing transfer pricing in Kenya. The Section requires that the business income from dealings between a resident person or a permanent establishment with a related non-resident person, be determined as if the parties are independent persons dealing at arm's length. The Income Tax (Transfer Pricing) Rules, 2006, provide guidelines to be applied by related enterprises in determining the arm's length prices of goods and service in transactions involving them. The Income Tax (Transfer Pricing Rules) 2006 heavily borrows from the OECD Transfer Pricing Guidelines.

6.3 Transfer Pricing Developments

6.3.1 Kenya's transfer pricing legislation has been enhanced over the years. Section 18(3) of the Income Tax Act has been in the Act since its enactment in 1973, but remained largely untested for several years until the hallmark transfer pricing case of Unilever (Kenya) Limited that was ruled in 2005. The audit conducted on Unilever (Kenya) Limited in 1998, revealed that Unilever (Kenya) charged lower prices to Unilever (Uganda) than those charged both to customers in Kenya and to unrelated parties in the export market both in Uganda and elsewhere. This led to a dispute that went to the courts of law. The case was ruled in favour of Unilever, based on two main reasons: that there were no regulations to guide the application of Section 18(3) at the time; and Section 18(3) was itself unclear, placing the burden of proof on the Commissioner and not on the taxpayer. Following the judgment in the case of *Unilever Kenya Ltd v Commissioner of Domestic Taxes* in 2005,[163] Kenya issued the Income Tax (Transfer Pricing Rules) 2006.

6.3.2 There have been subsequent legislation amendments on section 18(3) and other related sections:

- In 2010, the section was amended to get rid of the statement that required the Commissioner to prove that the transactions were arranged in such a way to reduce taxable profit;
- To minimize tax leakage through transfer pricing, section 18(6) was also amended in 2010 to include transactions between individuals who are related by consanguinity or affinity;
- Through Legal Notice No. 54 of 2012, the Commissioner may issue guidelines on application of the transfer pricing methods set out in the Transfer Pricing Rules;
- The Finance Act 2014 expanded the scope to include the dealings between a non-resident and its permanent establishment (PE); and
- The Finance Act 2017, introduced section 18A, that brought transactions with taxpayers in preferential regimes within the scope of Transfer pricing (in line with BEPS action 5 on Harmful Tax practices).

6.3.3 These amendments have eased the practical application of the transfer pricing legislation in Kenya. The transfer pricing legislation is now widely applied by both Kenya Revenue Authority (KRA) and the taxpayers in the determination of arm's length price. Several transfer pricing audits have since been conducted and disputes resolved, raising substantial revenues. Many companies with related party cross-border transactions have now registered their transfer pricing policies with the Commissioner.

6.4 Embracing the G20/ OECD BEPS Project Outcomes

6.4.1 Kenya has embraced internationally recognized guidelines namely UN and OECD Transfer Pricing Guidelines and the OECD Base Erosion and

[163] *Unilever Kenya* Ltd v *The Commissioner of Income Tax* (Income Tax Appeal no. 753 of 2003). High Court of Kenya. Available from, http://kenyalaw.org/caselaw/cases/view/12804

Profit Shifting (BEPS) project outcomes.

6.4.2 Kenya has embraced the BEPS outcomes and has gone ahead to implement some of the recommendations contained in the BEPS reports. Kenya is in the process of reviewing the Income Tax Act and KRA has proposed several amendments to be included in the revised Act to address BEPS issues. Some of the developments include:

a) Transactions with Companies in Low Tax Jurisdictions

The widening the definition of related parties within the meaning of international transactions to include companies in low tax jurisdictions, or tax havens to give lee way to transfer pricing review of transactions entered into with a company in a tax heaven even in situations where no relationship between the two companies is seen.

b) Preferential Tax Regimes

Kenya has expanded the scope of transfer pricing legislation to include transactions with related resident entities operating in preferential tax regimes, in line with BEPS action 5 on Harmful Tax practices.

c) Transfer Pricing Documentation

Kenya is in the process of enacting rules regarding transfer pricing documentation to enhance transparency. It has already developed a tax return that is meant to ensure that all the required information is disclosed. This is proposed to cover:

- CbC reporting;
- Disclosure of beneficial ownership;
- Domestic operations disclosures; and
- Imposition of penalties on failure to maintain and or avail transfer pricing documentation.

d) Widening the Scope of Permanent Establishment (PE)

Kenya is in the process of widening the scope of PEs to include activities that were omitted previously, for instance dependent agents, commissionaire agents among others. This is in line with BEPS Action 6.

e) Pricing of Commodities

Proposal to have an additional method for benchmarking commodities using data from international or domestic commodities markets. This is in addition to the conventional methods.

f) ***Enhancement of Dispute Resolution Under Mutual Agreement Procedure (MAP)***

Kenya is open to resolving tax disputes with countries which it has tax treaties with in line with BEPS Action 14.

g) ***Development of a Multilateral Instrument***

Kenya is already in the process of reviewing existing Double Tax Treaties (DTAs), identifying gaps within the DTAs to propose measures to address the gaps identified in the DTAs, In line with the outcome of BEPS Action 15.

6.5 Other Developments and Proposals

6.5.1 Other enhancements in tax legislation and administration to protect against base erosion and profit shifting from cross-border transactions include:

a) ***Mutual Administrative Assistance in Tax Matters (MAC)***

Kenya has ratified the Mutual Administrative Assistance in Tax Matters (MAC) agreement which is to be deposited with the OECD, promoting the ability to exchange tax information with other jurisdictions globally; upon request and later to enter into process of exchange of information automatically and spontaneously.

b) ***Management of Treaties***

Kenya is in the process of preparing a treaty policy and a treaty negotiation strategy which is meant to secure and safeguard taxing rights.

c) ***Proposal to Anchor Advance Pricing Arrangements (APA) in the Legislation***

Kenya has a framework for APA and has also made proposals to have APA anchored in law.

d) ***Kenya has already joined the Global Forum on Exchange of Information and Transparency.***

6.6 Tax Administration for Transfer Pricing Capacity Development

6.6.1 The Unilever (Kenya) Limited case was among the first transfer pricing audit cases conducted by KRA. Kenya Revenue Authority's (KRA) instituted the transfer pricing audit unit in 2009. This unit specialized in transfer pricing audits and has grown to what is now the International Tax

Office (ITO) with trained and dedicated staff, from less than 10 officers to the current level of about 40 officers. The unit has ensured adequate training of its staff through in-house training and collaboration with international organizations like the World Bank Group funded training programmes, among others.

6.6.2 KRA has committed resources to support transfer pricing audits through procurement of transfer pricing database for benchmarking studies and providing office equipment and facilities.

6.7 International Engagements

6.7.1 KRA has been engaged in many international platforms on transfer pricing and international tax matters, including active participation in regional bodies like the Africa Tax Administrators Forum (ATAF) and the East Africa Revenue Authorities Technical Committee (EARTC); participation in international transfer pricing seminars; having her staff take part in supporting transfer pricing audits in other countries under the OECD's Tax Inspectors Without Borders initiative; and having membership and participating in the OECD Working Parties under the OECD BEPS Inclusive Framework. Kenya has membership to OECD working parties such as:

- Action 1 Address the tax challenges of the digital economy;
- Action 5 Counter harmful tax practices more effectively, taking into account transparency and substance; and
- Actions 8, 9, 10 Assure that transfer pricing outcomes are in line with value creation.

6.8 Conclusion

6.8.1 Kenya has enhanced its tax legislation and worked towards aligning it with international practices to safeguard its revenue by sealing avenues that have caused revenue leakages. KRA's ITO is dedicated to keeping pace with the changing landscape in the taxation of cross border transactions.

UN Tax Committee

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