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United Nations

**Practical Manual on Transfer Pricing**

for Developing Countries (2017)

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# Department of Economic & Social Affairs

United Nations

**Practical Manual on Transfer Pricing**

for Developing Countries (2017)

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United Nations

New York, 2017

# Foreword to the Second Edition (2017)

**PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES**

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 embod- ied in it, and is consistent with relevant Commentaries of the

U.N. Model;

* That it reflects the realities for developing countries, at their rel- evant stages of capacity development;
* That special attention should be paid to the experience of devel- oping countries; and
* That it draws upon the work being done in other fora.

In carrying out its mandate, the Subcommittee shall in particu- lar 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 build- ing 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 reor- ganization into four parts as follows:

h Part A relates to transfer pricing in a global environment;

h 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 dis- cussion on the key topics. Chapter B.8. then demonstrates how some countries have established a legal framework to apply these principles;

h Part C addresses practical implementation of a transfer pric- ing regime in developing countries; and

h 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 recog- nition 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 draft- ing. [Part D]**1** is different from other chapters in its conception, however. It represents an outline of particular country admin- istrative practices as described in some detail by representa- tives from those countries, and it was not considered feasible or appropriate to seek a consensus on how such country prac- tices were described. [Part D] should be read with that differ- ence 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

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

three last-mentioned meetings being made possible by the generos- ity 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) contribut- ing 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 (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 Speyer (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 particu- lar, as well as Ilka Ritter and Tatiana Falcão, in this work is also acknowledged.

# 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 admin- istrative aspects of applying transfer pricing analysis to some of the transactions of multinational enterprises (MNEs) in particular. Such guidance should not only assist policy makers 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 Devel- oped 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 approxima- tion 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

2 United Nations, “Model Double Taxation Convention between Devel- oped and Developing Countries”, updated 2011. Available from: [http://www.](http://www/) un.org/esa/ffd/documents/UN\_Model\_2011\_Update.pdf

3 OECD, “Model Tax Convention on Income and Capital”.

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 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 avoid- ance 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 reve- nue 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,**4** there is reason to

4 See for example Alexander Yeats, “Just How Big Is Global Production Sharing?”, in *Fragmentation: New Production Pattern in the World Econo- my*, Sven Arndt and Henryk Kierzkowski, eds. (Oxford, Oxford University Press, 2001); Alfonso Irarrazabal, Andreas Moxnes and Luca David Opro- molla, “The Margins of Multinational Production and the Role of Intra-Firm Trade”, *Journal of Political Economy*, vol. 121, No.1 (February 2013) and Peter Egger and Tobias Seidel, “Corporate taxes and intra-firm trade”, July 2010. Available from [http://www.etsg.org/ETSG2010/papers/seidel.pdf.](http://www.etsg.org/ETSG2010/papers/seidel.pdf) The share of intra-firm trade is however, very difficult to measure, varies significantly between countries and depends on the definition of relevant relationships. See for example Rainer Lanz and Sébastien Miroudot, “Intra-Firm Trade:

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 transac- tions that detrimentally impact domestic revenues for development.

Conversely, in this complex area, there is a risk that taxpayers, espe- cially MNEs, will be faced with a multiplicity of approaches to apply- ing 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 understand- ings on transfer pricing issues can also improve trust between taxpay- ers and tax authorities, both avoiding some differences between them and helping resolve others more quickly.

In offering practical guidance to policy makers 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 coun- tries, along with their capabilities, will evolve over time. A “phased” or “life cycle” approach, with a transfer pricing capability strategy identi- fying 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

Patterns, Determinants and Policy Implications”, OECD Trade Policy Work- ing Papers, No. 114, (Paris, OECD, 2011). Available from [http://search.oecd.](http://search.oecd/) org/officialdocuments/displaydocumentpdf/?cote=TAD/TC/WP(2010)27/ FINAL&docLanguage=En at page 12 following.

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 govern- ment 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 rec- ognition 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 practical- ity — addressing real issues for developing countries (and of course those dealing with the administrations of such coun- tries) 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 develop- ment of fair and effective tax systems, but also the fact that for- eign 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’ admin- istrations, 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 devel- oping 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 effec- tive ways; and
* Consistency with the OECD Transfer Pricing Guidelines**5** has been sought, as provided for in the Subcommittee’s man- date 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 capa- bility 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:**6** 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, US); Michael Kobetsky (Australian National University & 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).

5 OECD, “Transfer Pricing Guidelines for Multinational Enterprises”.

6 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.

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 valu- able 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 consid- ered 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 particu- lar persons involved in its drafting. Chapter 10 is different from other chapters in its conception, however. It represents an outline of particu- lar country administrative practices as described in some detail by representatives from those countries, and it was not considered feasi- ble 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 pric- ing principles, this Manual frequently refers to hypothetical exam- ples, such as in relation to Chapter 5 on Comparability Analysis and Chapter 6 on Methods. Such examples are intended to be purely illus- trative, 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 devel- oping 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.

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# Part A

# TRANSFER PRICING IN A GLOBAL ENVIRONMENT

## A .1 . INTRODUCTION

* + 1. This chapter provides background material on Multi- national Enterprises (MNEs); MNEs are a key aspect of globalization as they have integrated cross-border business operations. The chap- ter describes the factors that gave rise to MNEs and shows how an MNE is able to exploit integration opportunities in the cross-border production of goods and provision of services through a value chain (or value-added chain).
    2. MNEs are groups of companies and generally oper- ate worldwide through locally incorporated subsidiaries or perma- nent establishments; they may also use other structures such as joint ventures and partnerships. At the operational level, an MNE’s busi- ness operations may be organized in several different ways such as a functional structure, a divisional structure or a matrix structure. This chapter outlines the legal structures that may be used by MNEs, and considers the differences between them.
    3. This chapter then uses a “value chain analysis” (see Paragraphs A.2.5 and A.3.5 below) as a measure for testing the performance of an MNE. It considers the management of the trans- fer pricing function in an MNE to minimize the risk of transfer pric- ing adjustments and to avoid double taxation. While MNEs test the performance of their business operations, for tax and company law purposes they are required to report the performance of associated entities in the countries in which they operate. An MNE’s transfer pricing policy should provide guidance on: transfer pricing documen- tation requirements; reporting for transfer pricing purposes; dealing with audits; and appropriate measures for dispute resolution with a tax authority.

## A .2 . Theory of the Firm and Development of Multinational Enterprises

* + 1. In economic theory, 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 would be carried out through a series of arm’s length transactions between independent parties.**7** These trans- actions would require contracts between the independent producers but a significant part of these resources would be used in the process of making contracts.
    2. The expenses of making contracts are called “transac- tion costs” since expenses are incurred by individuals in finding other persons with whom to contract, as well as in negotiating and finalizing the contracts. As contracts cannot cover every possible issue that may arise between the contracting parties, there is a risk of disputes being created by unforeseen contingencies. When disputes occur between contracting parties they may incur considerable costs in resolving these disputes including negotiation costs, legal expenses, and litigation and mediation expenses. As transactions and associated costs would be significant in an economy without firms, it is rational for firms to be created to produce goods and services, provided that the firms’ costs of production are less than the costs of outsourcing the production.
    3. Within a firm, contracts between the various factors of production are eliminated and replaced with administrative arrange- ments. Usually, the administrative costs of organizing production within a firm are less than the cost of the alternative, which is outsourc- ing market transactions. The theoretical limit to the expansion of a firm is the point at which its costs of organizing transactions are equal to the costs of carrying out the transactions through the market.
    4. A firm will internalize the costs of production to the extent that it can achieve economies of scale in production and distribution

7 UNCTAD, “World Investment Report 1993: Transnational Corpora- tions and Integrated Production”, (“World Investment Report 1993”) (New York, 1993). Available at <http://unctad.org/en/Docs/wir1993_en.pdf>, at p. 115; Ronald Coarse, “The Firm, the Market and the Law”, (Chicago: University of Chicago Press, 1988) at p. 7.

and establish coordination economies. The United Nations Conference on Trade and Development (UNCTAD) in its *1993 World Investment Report: Transnational Corporations and Integrated Production***8** noted that in many industries the expansion of internalized activities within multinational enterprises indicates that there are significant efficiency gains that may be achieved.

* + 1. A firm’s functions in providing goods and services are collectively called its supply chain, through which the firm converts inputs into goods and services. Most firms begin by operating in their home market and rely on their competitive advantages to enter markets abroad. The term “supply chain” is defined as “the chain of processes involved in the production and distribution of a commodity.”**9** In this chapter the term “supply chain” is used for the provision of both goods and services by MNEs. The term “value chain” is defined in this Manual as “the process or activities by which a company adds value to an article, including production, marketing, and the provision of after-sales service.” **10**
    2. MNEs create organizational structures and develop strat- egies to arrange the cross-border production of goods and services in locations around the world and to determine the level of intra-entity or intra-group integration. UNCTAD considered that there was a trend in many MNEs across a broad range of industries to use structures and strategies with high levels of integration in their operations. The integration included structures giving an associated enterprise control over a group-wide function or the sharing of group-wide functions between two or more enterprises.**11**
    3. Successful MNEs use their location and internalization advantages to maximize their share of global markets and growth opportunities. Thus, multinational enterprises are able to minimize

8 Idem, fn. 7 (World Investment Report 1993): Idem at pp 7 and 153-154 especially.

9 Oxford English Dictionary Online; https://en.oxforddictionaries.com/ definition/supply\_chain

10 Oxford English Dictionary Online; https://en.oxforddictionaries.com/ definition/value\_chain.

11 Supra fn.7 (“World Investment Report 1993”) at p. 158 and following.

their costs through their integration economies, which **are not availa- ble to domestic firms**.

* + 1. The key feature of MNEs is that they are integrated (global) businesses. Globalization has made it possible for an MNE to achieve high levels of integration and the ability to have control centralized in one location. Modern information and communications systems also provide increased horizontal communications across geographic and functional business lines. This has resulted in many MNEs provid- ing 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, leading the MNE from several locations.
    2. In order to optimize the value chain, MNEs may establish new business operations in a developing country. These investments often happen in stages, with the initial stage involving the establish- ment of infrastructure, improvement of the **education of individuals and accordingly, provision of economic benefits to the country**.
    3. MNEs have common control, common goals and common resources, and the units of the enterprise — parent company, subsid- iaries 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 that integration of production by MNEs creates challenges for policy-makers in adapting the meth- ods for allocating the income and costs of MNEs between jurisdictions for tax purposes.
    4. In *Multinational Enterprises and the Global Economy* (2008)**12** 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 integrated their oper- ations until the late 1980s and then more recently chose to outsource some activities in which they do not have competitive advantages.

12 John Dunning and Sarianna Lundan, “Multinational Enterprises and the Global Economy”, 2nd edition, (Cheltenham, Edward Elgar, 2008) at p.197.

* + 1. For most of the twentieth century, 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 firms had integrated their production and marketing func- tions. Up to the 1960s and 1970s, MNEs had engaged in limited or no outsourcing of operations and they became large integrated conglom- erates. But the authors argue that from the late 1980s MNEs began outsourcing many activities that were previously performed by the firms themselves.**13** From the early 1990s, MNEs began restructuring to specialize in the areas in which 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.
    2. MNEs examined their value chains to identify the functions in which they had no advantage over other firms.**14** They then began deciding on which functions they would perform themselves and which functions would be outsourced to independent firms, a process called value chain optimization. For in-house services, MNEs might 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, 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 independent firms in countries which have educated workforces and relatively low-cost labour. Consequently, modern MNE groups organize their cross-border opera- tions through a network of contractual arrangements with independent enterprises and cooperative in-house relationships.
    3. 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 incur the additional requirement of complying with transfer pricing rules. Some SMEs may face challenges in complying with transfer pric- ing rules because of their lack of expertise with international tax issues in general and limited compliance resources that may hinder them from

13 Idem, p. 196.

14 Ibid.

expanding their operations abroad. 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 them. Some countries may have special simplified rules for SMEs, such as simpli- fied 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.

## A .3 . Legal Structure

## A .3 .1 . General Principles of Company Law

* + - 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 countries such as Australia, Canada, India, Malaysia, New Zealand and the USA. The common law is based on judgments in court cases. A judgment of a superior court is binding on lower courts in future cases. The civil law system has its origins in Roman law and operates in Europe, South 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 perpet- ual life and limited liability. The domestic law treatment of a partner- ship varies in common law and civil law countries.
      2. Most countries treat partnerships as fiscally transparent entities with flow-through treatment under which the partnership is ignored and tax is imposed on the partners according to their respec- tive shares of partnership income. Other countries treat partnerships as taxable units subject to taxation as entities, including company treat- ment. Some countries such as the USA have limited liability compa- nies which provide the benefit of limited liability and allow the entity to choose either flow-through treatment or treatment as a taxable unit. This is called the “check the box” system and the entities are referred to as “hybrids”. A feature of common law countries is the “trust” concept which is an obligation in relation to property which allows for concur- rent legal and beneficial ownership of the trust property. A trustee will be the legal owner of property but holds the property on trust for the

beneficiaries which may include both income and capital beneficiar- ies. While business operations may be carried on in some common law countries using a trust structure, MNEs would not normally use trusts to carry on business operations.

* + - 1. One of the key decisions facing any MNE when expand- ing its operations to another country is the type of legal structure it will use to operate in that jurisdiction. The alternatives for an MNE are to operate abroad through locally incorporated subsidiary compa- nies (associated enterprises) or operate abroad using permanent estab- lishments (branches). Foreign subsidiaries may be either fully-owned by the parent company or partly-owned.
      2. An MNE is a group of companies or other entities and under the company law of the country in which each company is incor- porated it is a legal entity. This choice of legal structure will be affected by a number of factors, apart from the tax implications, including:
         * Legal liability;
         * Risk and control; and
         * Administrative and regulatory obligations and costs.
      3. Other factors which may affect the choice of the legal form of the enterprise include:
         * Exchange controls;
         * Requirements for minimum shareholding by local persons or entities;
         * Administrative costs;
         * Extraction of profits; and
         * Capital requirements.
      4. MNEs may also carry on business abroad through a part- nership or joint venture. In most jurisdictions partnerships are not legal entities and are fiscally transparent. For a partnership to exist, an MNE would require other entities to be partners such as independ- ent entities or subsidiaries. Joint ventures involve independent compa- nies working together on a specific project and a joint venture party may include a government or a government authority. The business structures used by an MNE may change over time such as, for exam- ple, commencing operations in a jurisdiction using a joint venture

structure and then buying out the joint venture partner and operat- ing in that jurisdiction through an associated enterprise. An MNE may also operate abroad using an agent, which may be an independent agent, a dependent agent or a commissionaire.

## A .3 .2 . Companies and Permanent Establishments

* + - 1. In an MNE group, the parent company and subsidiary companies are separate legal entities and they may enter into intra-group transactions. On the other hand, an international enterprise with a head office in the country of residence and permanent establishments abroad is one legal entity and a permanent establishment cannot legally enter into transactions with other parts of the enterprise because transactions require at least two legal entities. In the context of the Business Profits article of some tax treaties, notional transactions within an international enterprise (either between a head office and its permanent establishment or between permanent establishments) may be recognized provided they comply with the arm’s length principle. In addition, for accounting and management purposes, the head office of an international enterprise and a branch may be treated as “transacting” with each other. Whether or not dealings between a head office and its branch are subject to transfer pricing rules would depend on the scope of a country’s domestic legisla- tion and its tax treaties.
      2. Operational structures used by MNEs vary and evolve over time. There are many types of structures or hybrids which an organization can choose to adopt, but an organization’s primary aim should be to adopt an operational structure that will most effectively support and help it to achieve its business objectives. MNE opera- tional structures usually differ from the legal structures and as a result, employees generally operate beyond and across the boundaries of legal entities and countries. Examples of the types of modern operational structures an MNE may adopt include a functional structure, a divi- sional structure or a matrix structure as outlined below.

## A .3 .3 . Types of Organizational Structures

* + - 1. In a **functional structure** an MNE’s functions are performed by the employees within the functional divisions. These

functions are usually specialized tasks, for instance the information technology engineering department would be staffed with software engineers. As a whole, 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 produc- ing a limited amount of products or services efficient and predictable.

* + - 1. Under a **divisional structure**, each organizational func- tion 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 prod- uct/service basis (e.g. different products for different customers: house- holds or companies). For example, an automobile company may have a divisional structure with a division for hybrid cars and another divi- sion for other cars with each of these divisions having its own sales, engineering and marketing departments.
      2. The **matrix structure** groups employees by multiple criteria with the most common criteria being function and prod- uct. Alternative criteria would be function and geographic location. 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:

Product A/Americas; Product B/Americas; Product A/Asia-Pacific; Product B/Asia-Pacific;

Product A/Europe, Middle East, Africa (EMEA); Product B/EMEA.

In terms of this matrix structure a person in the Product A division in Brazil may report to the head of the Global Product A division and the head of the Americas division.

## A .3 .4 . Financial Reporting

A.3.4.1. An MNE customarily maintains, parallel to its statutory accounts, a set of management accounts to mirror its operational structure in order to measure and report on the effectiveness of each operational unit for management purposes. Some of these divisions may be classified as cost centres for management account purposes (e.g. the human resources division) whilst others may be classified as profit centres (e.g. the product/services division). It is often chal- lenging for an MNE to attempt to segregate the corporate and stat- utory financial statements to reflect the organization’s operational structure.

## A .3 .5 . Value Chain Analysis

* + - 1. The aim of MNEs is to maximize profits from produc- ing goods and services. The key feature of an optimal MNE business is to produce a profit from exploiting resources which produce prop- erty or services of greatest economic value. A useful starting point to understand how an MNE operates is a value chain analysis which will also form the basis for a transfer pricing functional analysis. An MNE’s value chain is 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 value chain.
         3. Comparing the generic value chain to an MNE’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, which may distinguish the MNE from its competitors, i.e. value-adding activities.
         7. Understanding and confirming how the various functions across the value chain are split by the MNE between the various legal entities in the group.
      2. The following example shows how three different MNEs could adopt different operational structures using the same generic value chain.

**MNE Group 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 manufactur- ing company (i.e. not a limited-risk contract manufacturer, for example) which also performs some functions on the design and practical application of its products.

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

**MNE Group 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 Group 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 Group 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. 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.
      2. For example, in MNE group A (see Figure A.1 below) the value chain is defined as Company 1 performing R&D, Company 2 manufacturing, and Company 3 distributing the MNE’s products. The value chain, however, may be different depending on the legal and contractual arrangements between the companies.
      3. One possible context could be that Company 1 performs R&D at its own risk, and is the legal owner of any intangible prop- erty 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.
      4. A different possible context of exactly the same 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 devel- oped through that R&D; and Company 3 acts as a limited risk distrib- utor through a contractual arrangement with Company 2. In this case, Company 2 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.
      5. A different possible structure of the same 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 devel- oped 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

Part A: Transfer Pricing in a Global Environment

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Figure A.1:

### Value Chain Analysis

**R&D**

**Design**

**Production**

**Marketing**

**Distribution**

**Customer Service**

**Group C**

**3rd Party**

**Company 1 & 2 & 3**

**Company 2**

**3rd Party**

**Company 2**

**3rd Party**

**ny 1**

**Compa**

**Company 3**

**Company 2**

**1**

**Company**

**Group B**

**Group A**

Raw Materials

Finished Goods

\*Examples of how different groups could “customize” the above generic value chain

the MNE, and bears substantial risk associated with the manufactur- ing and sales of the MNE’s products.

* + - 1. As will be discussed in subsequent chapters, each of these different contexts would very likely result in different transfer pricing outcomes.**15**

## A . 4 . Managing the Transfer Pricing Function in a Multinational Enterprise

* + 1. MNEs face challenges in managing their transfer pric- ing 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 allo- cation of taxable income among the associated enterprises of an MNE group.
    2. Entities in an MNE group conduct global business that gives rise to opportunities to optimize the value chain of goods or services and 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 accept- able to the tax authorities in the countries in which the MNE oper- ates. 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.
    3. Financial reporting for MNEs is informed by two deci- sion trees. On the one hand, corporate and tax law require an associ- ated enterprise to determine its taxable income derived from a specific jurisdiction. On the other hand, an MNE will usually need to deter- mine for management purposes the income and costs of its businesses lines, which, as the previous discussion shows, can operate across

15 Contractual arrangements are not simply taken at face value by tax authorities. For example, each of these different possible contexts of MNE Group A’s value chain would be subject to evaluation to ensure that the eco- nomic 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.

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, particularly those where the parent is listed on a stock exchange, are more likely to aim to meet their tax obligations in the countries in which they operate provided that they are not subject to double taxation. Consequently, 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. The following is an illustrative example of the two differ- ent decision trees within an MNE:

Figure A.2:

### Multinational Enterprise Decision Trees

***Global Business 1***

***Global Business 2***

***Global Business 3***

Legal Entities

Legal Entities

Legal Entities

Joint Ventures

Joint Ventures

Joint Ventures

Partnerships

Partnerships

Partnerships

Branch

Branch

Branch

* + 1. The allocation of profits and costs to the various legal structures is based on the functions performed, risks assumed and assets employed. Since MNEs consist of numerous associated enter- prises it is very difficult to allocate the profits and costs to all the sepa- rate legal entities due to the absence of market forces. It is a complex exercise to come up with a consistent global policy for allocating results to the legal structures.
    2. The arm’s length principle allows national tax author- ities to make an adjustment to the profits of one enterprise where the terms of transactions between associated enterprises differ from terms that would be agreed between unrelated enterprises in simi- lar circumstances. A tax authority should only disregard a controlled transaction in exceptional circumstances. If the terms of a transac- tion between associated enterprises differ from those between unre- lated parties and comparisons are difficult to make, an MNE bears the risk of transfer pricing adjustments. If the income of an associ- ated enterprise within Country A is increased as a result of a transfer pricing adjustment, it would be reasonable to expect that there would be a corresponding transfer pricing adjustment resulting in a propor- tionate reduction in the income of the other associated enterprise in Country B, provided a consistent transfer pricing method is used by both countries.
    3. But Country B may use different transfer pricing meth- ods. Consequently, if transfer prices are adjusted by a tax authority in one country, double taxation will occur if the tax authority in the other country does not use the same transfer pricing method and allows a corresponding transfer pricing adjustment. It is the task of the trans- fer pricing function within an MNE to limit the risk of transfer pric- ing adjustments and the risk of double taxation. See the illustration of double taxation below in Figure A.3.
    4. In principle, designing, implementing and documenting an appropriate transfer pricing policy should not be viewed solely as a compliance issue for MNEs. The main goal should be to develop a consistent global policy which cannot be altered to exploit tax laws. A well-developed and consistently applied transfer pricing policy should reduce an MNE’s risk of transfer pricing adjustments and the poten- tial 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.
    5. An MNE’s transfer pricing policy should ideally reduce the risk of transfer pricing adjustments and the risks of double taxa- tion of cross-border transactions. A comprehensive transfer pricing policy should cover four key areas as shown in Figure A.4.
       - Advisory;
       - Reporting;
       - Documentation; and
       - Audit support/Dispute resolution.

Figure A.3:

**Global Effect of Transfer Pricing Adjustments** *(before adjustment)*

|  |  |
| --- | --- |
| Global Business 2 | |
| Global Business 1 | Global Business 3 |
| DT | DT |

* Country challenges amount of profit reported by legal entity and makes an adjustment
* Consequence: total global profit increases
* End result: Some profit is taxed twice (double taxation, DT)

Figure A.4:

### Aspects of Transfer Pricing Policy

* Business restructuring
* Cross-border movement of goods, services
* Structuring activities
* Global risk assessment

Advising

Reporting

* + - * + Knowledge of tax authorities
        + Managing tax audits
        + Technical expertise
        + Litigation
        + MAP
        + APA

Audit support/ Dispute resolution

Documentation

Cohesive documents, both global/regional and local

Customised policy

Optimised defence

United Nations Practical Manual on Transfer Pricing (2017)

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* + 1. **Advising** requires a thorough knowledge of an MNE’s busi- ness operations. It is 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 into the MNE’s global business strategy. Advice can be provided to minimize the risk of transfer pric- ing adjustments and therefore optimize the business opportunity if the tax department is involved in an MNE’s decision-making.
    2. In today’s environment there is an increasing level of detail required to meet each country’s transfer pricing documentation requirements. Most MNEs therefore prepare global and regional docu- mentation (master files) of the various global businesses. Subsequently, global and regional reports are prepared for local purposes based on the identified risks for each country in which the MNE operates.
    3. Tax authorities around the world are increasingly focussed on transfer pricing and on expanding their transfer pricing capabili- ties. MNEs have to find a way to deal with the increasingly detailed, complex and often conflicting domestic transfer pricing legislation in the countries where they operate. Some countries follow guidance from international bodies, others only implement part of the guidance while some develop transfer pricing rules independently.
    4. Tax authorities should not start from the assumption that MNEs are manipulating their results in order to obtain tax bene- fits. Many MNEs and certainly those with shares quoted on a stock exchange (listed MNEs) have published codes of conduct or a set of business principles or both. These codes or principles 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.
    5. As transfer pricing is often referred to as “an art, not a science”, the resulting uncertainty creates the potential for transfer pricing disputes with tax authorities, even if the MNE is seeking to comply with domestic transfer pricing rules. Despite the efforts MNEs invest in setting the appropriate transfer prices and preparing compre- hensive documentation, there is always the risk that tax authorities disagree with the approach taken and there is thus the risk of a trans- fer pricing adjustment. This creates uncertainty for MNEs including

the potential associated costs of preparing additional documentation, managing tax audits and conducting litigation. Notwithstanding this, there are cases where transfer prices are manipulated to shift prof- its from one jurisdiction to another to gain tax benefits including low-taxation or no-taxation.

* + 1. Transfer pricing rules are considered very useful by MNEs if they are able to achieve a globally consistent approach and elimi- nate the risk of transfer pricing disputes. If in one country an MNE’s transfer prices are adjusted, resulting in a higher taxable income, the associated enterprise in the other country should in principle**16** receive a “corresponding adjustment”, reducing its taxable income. If there is no corresponding adjustment, 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.
    2. Countries should try to avoid such double taxation, though 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 important that the two countries enter into discussions to resolve the double taxation issue under the mutual agreement proce- dure mechanism in a tax treaty.
    3. The following diagram illustrates a transfer pricing adjust- ment to relieve double taxation:

16 UN and OECD Model Tax Conventions, Article 9 (Associated Enterprises).

Figure A.5:

**Global Effects of Transfer Pricing Adjustments** *(after adjustment)*

|  |  |  |  |
| --- | --- | --- | --- |
| Global Business 2 | | | |
| Global Business 1 | | Global Business 3 | |
| A |  |  | A |
|  | P | P |  |

* Adjustment (A) is basically a profit allocation issue between countries
* Adjustment upwards of profit (P) in Country 1 must result in corresponding adjustment in Country 2

# Part B

# DESIGN PRINCIPLES AND POLICY CONSIDERATIONS

## B .1 . INTRODUCTION TO TRANSFER PRICING

## B .1 .1 . What is Transfer Pricing?

* + - 1. This introductory chapter gives a brief outline of the subject of transfer pricing and addresses the practical issues and concerns surrounding it, especially the issues faced and approaches taken by developing countries. These are then dealt with in greater detail in later chapters.
      2. Rapid advances in technology, transportation and commu- nication have given rise to a large number of multinational enterprises (MNEs) which have the flexibility to place their enterprises and activ- ities anywhere in the world, as outlined in Part A of this Manual.
      3. A significant volume of global trade consists of interna- tional transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within an MNE group; such transfers are called “intra-group transactions”. There is evidence that intra-group trade has been growing steadily since the mid-20th century and arguably accounts for more than 30% of all international transactions.
      4. 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.
      5. The structure of transactions within an MNE group**17** is determined by a combination of the market and group driven forces

17 The component parts of an MNE group, such as companies, are called “associated enterprises” in the language of transfer pricing.

which can differ from the open market conditions operating between independent entities. A large and growing number of international transactions are therefore not governed entirely by market forces, but driven by the common interests of the entities of a group.

* + - 1. In such a situation, it becomes important to establish the appropriate price, called the “transfer price”, for intra-group, cross-border transfers of goods, intangibles and services. “Transfer pricing” is the general term for the pricing of cross-border, intra-firm transactions between related parties. Transfer pricing therefore refers to the setting of prices**18** for transactions between associated enter- prises involving the transfer of property or services. These transac- tions are also referred to as “controlled” transactions, as distinct from “uncontrolled” transactions between companies that are not associated and can be assumed to operate independently (“on an arm’s length basis”) in setting terms for such transactions.
      2. Transfer pricing thus 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 inter- nationally 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 poten- tially arise. Two examples illustrate these points:

**Example: Solid State Drive Manufacturer**

* In the first example, a profitable computer group in Country A buys “solid state drives” from its own 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 Country B unit reports and how much local tax it pays. If the parent pays the subsidiary a price that is lower than the appropriate arm’s length price, the Country B unit 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.

18 However, in most cases the transfer pricing analysis will end after an appropriate profit margin has been determined. See Chapter B.3 on Transfer Pricing Methods.

* From the perspective of the tax authorities, Country A’s tax authorities might agree with the profit reported at their end by the computer group in Country A, but their Country B counterparts may not agree - they may not have the expected profit to tax on their side of the operation. If the computer company in Country A bought 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. This approach gives scope for the parent or subsidiary, whichever is in a low-tax jurisdiction, to be shown as making a higher profit by fixing the transfer price to that effect and thereby minimizing its 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.

**Example: Luxury Watch Manufacturer**

* In a second example, a luxury watch manufacturer 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 company in Country B is audited by Country B’s tax administration they notice that the distributor itself does not earn a profit: the $1500 transfer price plus the Country B unit’s

$100 distribution costs are exactly equal to the $1600 retail price. Country B’s tax administration considers that the transfer price should be set at $1400 so that Country B’s unit shows the group’s

$100 profit that would be liable for tax.

* This poses a problem for the parent company, as it is already paying tax in Country A on the $100 profit per watch shown in its accounts.
* Since it is a multinational group it is liable for tax in the coun- tries where it operates and in dealing with two different tax authorities it is generally not possible to just cancel one out against the other. So the MNE can end up suffering double taxation on the same profits where there are differences about what constitutes the appropriate transfer pricing.
  + - 1. A possible reason for associated entities charging trans- fer prices for intra-group trade is to measure the performance of the individual entities in a multinational group. The individual enti- ties within a multinational group may be separate profit centres and transfer prices are required to determine the profitability of the enti- ties. 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 prod- ucts 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 gravi- tate towards the “arm’s length price”, i.e. the transaction price to which two unrelated parties would agree.
      2. While the above 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 in identi- fying and valuing intangibles transferred and/or services provided. For example, intangibles could be of various different types such as indus- trial assets like patents, trade types, 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. There are thus many complexities involved in dealing with transfer pricing in cross-border transactions between MNE entities.
      3. Transfer pricing is a term that is also used in economics, so it is useful to see how economists define it. In business econom- ics a transfer price is considered to be the amount that is charged by a part or segment of an organization for a product, asset or service that

it supplies to another part or segment of the same organization. This definition is therefore consistent with the approach described above.

## B .1 .2 . Basic Issues Underlying Transfer Pricing

* + - 1. Transfer prices serve to determine the income of both parties involved in the cross-border transaction. The transfer price therefore influences the tax base of the countries involved in cross-border transactions.
      2. In any cross-border tax scenario, the parties involved are the relevant entities of the MNE group along with the tax authori- ties of the countries involved in the transaction. When one country’s tax authority adjusts the profit of a member of the MNE group, this may have an effect on the tax base of another country. In other words, cross-border tax situations involve issues related to jurisdiction, allo- cation of income and valuation.
      3. The key jurisdiction issues are: which government should tax the income of the group entities engaged in the transaction, and what happens if both governments claim the right to tax the same income? If the tax base arises in more than one country, should one of the governments give tax relief to prevent double taxation of the rele- vant entities’ income, and if so, which one?
      4. An added dimension to the jurisdictional issue is that of the motivation for transfer pricing manipulation, as some MNEs 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 intra-group transactions, it is not the only factor that determines transfer pricing policies and practices.
      5. The aim of non-arm’s length transfer pricing in such cases is usually 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 under-charging or over-charging the associated entity for intra-group trade. For example, if the parent company in an MNE group has a tax rate in the residence country of 30%, and has a subsidiary resident

in another country with a tax rate of 20%, the parent may have an incentive to shift profits to its subsidiary to reduce its tax rate on these amounts from 30% to 20%. This may be achieved by the parent being over-charged for the acquisition of property and services from its subsidiary.

* + - 1. While the most obvious motivation may be to reduce the MNE’s worldwide taxation, other factors may influence transfer pric- ing decisions, such as imputation of tax benefits in the parent compa- ny’s country of residence.
      2. A further motivation for an MNE to engage in such prac- tices 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, an international enterprise 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 associ- ated company, the international enterprise 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.
      3. MNEs are global structures which may share common resources and overheads. From the perspective of the MNE these resources need to be allocated with maximum efficiency in an opti- mal manner.
      4. From the government’s perspective, the allocation of costs and income from the MNE’s resources is an essential element in calcu- lating the tax payable. There can thus be a dispute between countries in the allocation of costs and resources, owing to their objective of maximizing the tax base in their respective jurisdictions.
      5. From the MNE’s perspective, any trade or taxation barri- ers 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 group members for tax purposes. This is especially true in the case of intan- gibles and service-related intra-group transactions.
      6. Mere allocation of income and expenses to one or more members of the MNE group is not sufficient; the income and expenses must also be *valued*. A key issue of transfer pricing is therefore the valuation of intra-group transfers.
      7. As an MNE is an integrated structure with the ability to exploit international differentials and to utilize economies of integra- tion not available to a stand-alone entity, transfer prices within the group are unlikely to be the same prices that unrelated parties would negotiate.
      8. 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 smaller tax administrations.
      9. 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.
      10. Another set of challenges involve transfer pricing issues related to business restructuring and intra-group services. Transfer pricing documentation requirements for MNE’s represent one more key focus area given the evolution of stringent documentation stand- ards, including country-by-country reporting, not to mention the increasing information exchange between governments on interna- tional transactions.
      11. All these basic and critical transfer pricing issues are addressed in detail in this Manual in separate chapters.
      12. Overall, it should be amply clear that transfer pricing rules are essential for countries in order to protect their tax base, to elimi- nate double taxation and to enhance cross-border trade. For develop- ing 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 hence detailed transfer pricing rules are essential.

## B .1 .3 . Evolution of Transfer Pricing

* + - 1. This section aims to trace the history and the reasons for transfer pricing taxation regimes. It is important to note that trans- fer 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. The OECD Transfer Pricing Guidelines (OECD Guidelines) as amended and updated, were first published in 1995. This followed previous OECD reports on transfer pricing in 1979 and 1984. The OECD Guidelines represent a consensus among OECD Members, mostly developed countries, and have largely been followed in domes- tic transfer pricing regulations of these countries. Another transfer pricing framework of note which has evolved over time is represented by the USA Transfer Pricing Regulations (26 USC 482).
      3. Special attention must be focused on the meaning and scope of the term “associated enterprises”, which is a topic of impor- tance but one not defined or discussed adequately so far. This issue is discussed in more detail below.
      4. From a financial perspective, transfer pricing is proba- bly 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.
      5. Parent companies of large MNE groups usually have inter- mediary or sub-holdings in several countries around the world. From a management perspective, the decision-making in MNE groups may range from highly centralized structures to highly decentralized struc- tures with profit responsibility allocated to individual group members. Such group structures typically include:
         * Research and development (R&D) and services that may be concentrated in centres operating for the whole group or spe- cific parts of the group;
         * Intangibles, developed by entities of the MNE group; these may be concentrated around certain group members;
         * Finance and “captive insurance companies”**19** which may oper- ate as insurers or internal finance companies; and
         * Production units, where the production or assembly of final products may take place in many countries around the world.
      6. The on-going 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 infra- structure, 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 last couple of decades.
      7. Other considerations have also had an impact on the importance of transfer pricing. Some developed countries have tight- ened their transfer pricing legislation to address the issue of foreign enterprises active in their countries paying lower tax than compara- ble domestic groups. Consequently, 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.
      8. Countries with less sophisticated tax systems and admin- istrations have run the risk of absorbing the effect of stronger enforce- ment of transfer pricing in developed countries and in effect paying at least some of the MNEs’ tax costs in those countries. In order to avoid this, many countries have introduced new transfer pricing rules.
      9. The OECD Committee on Fiscal Affairs continues to monitor developments in transfer pricing, in particular developments in the use of profit-based methods, and in comparability matters. The recent thrust of the OECD has been studying, along with G20 coun- tries, the current international taxation rules to identify weakness which may result in opportunities for Base Erosion and Profit Sharing (BEPS). In September 2013, the OECD launched the Action Plan on BEPS initiative which identified 15 actions aimed at providing new

19 Insurance companies within a group having the specific objective of insuring group risks.

or reinforced international standards and measures to help countries tackle BEPS. The OECD BEPS initiative released 7 preliminary reports in 2014 and followed it with the release of a final package of 15 reports, one for each Action Plan, at the G20 Finance Ministers meeting in October 2015. The Action Plans provide Model provisions to prevent treaty abuse; call for standardized Country-by-Country Reporting in terms of documentation requirements; elucidate a peer review process for addressing harmful tax practices; endorse a minimum standard to secure progress on dispute resolution and make many other such recommendations.

* + - 1. While the OECD BEPS initiative, theoretically, is aimed at revamping international tax standards to keep pace with the chang- ing global business environment, the practical implementation of such BEPS 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 — which is yet to happen.
      2. It is to be noted that the OECD TP Guidelines have emerged from Article 9 of the OECD Model Convention; they have also been applied in the context of the UN Model Double Tax Convention. However, developing countries have found it very difficult to imple- ment such guidelines in practice. There are presently five different prescribed transfer pricing methods (see Chapter B.3.) that may be used under the OECD Guidelines in various situations to arrive at an arm’s length price. However, while these methods may be able to provide a computation of the arm’s length price (i.e., an appropriate transfer price) within the MNE, in practice disagreements between tax author- ities in applying these methods may result in taxable profits between two MNEs being either more than 100% or less than 100% of actual combined profits. This situation could arise as a result of adjustments carried out by one tax authority without corresponding adjustments by the tax authority in the other country, where such adjustments are not endorsed in the relevant double taxation treaty.
      3. The European Commission has also developed proposals on income allocation to members of MNEs active in the European Union (EU). Some of the approaches considered have included the possibility of a “common consolidated corporate tax base (CCCTB)”

and “home state taxation”.**20** Under both options transfer pricing would be replaced by formulary apportionment, whereby taxing rights would be allocated between countries based upon the apportionment of the European business activity of an MNE conducted in those coun- tries. Apportionment would be under an agreed formula, based upon some criteria of business activity such as some combination of sales, payroll, and assets. In recent years, the EU Joint Transfer Pricing Forum**21** has developed proposals to improve transfer pricing dispute resolution (Mutual Agreement Procedure, arbitration and Advance Pricing Arrangements), and a proposal to harmonize transfer pric- ing documentation requirements. The proposals on EU transfer pric- ing documentation requirements and on the implementation of the EU Arbitration Convention have been adopted as “Codes of Conduct” by the EU Council. The EU Council also issued, on 17 May 2011, some guidelines on low-value-adding intra-group services; they are endorsed on the basis that their implementation should contribute to reducing tax disputes. In January 2016, the European Commission also published a Communication on a “Fair and Efficient Corporate Tax System in the European Union” which aims to set out how the OECD/G20 BEPS measures can be implemented within the EU.**22**

* + - 1. The United Nations for its part published an important report on “International Income Taxation and Developing Countries” in 1988.**23** The report discusses significant opportunities for transfer pricing manipulation by MNEs to the detriment of developing coun- try tax bases. It recommends a range of mechanisms specially tailored to deal with the particular intra-group transactions by developing countries. The United Nations Conference on Trade and Development (UNCTAD) also issued a major report on Transfer Pricing in 1999.**24**

20 See, for more detail, <http://ec.europa.eu/taxation_customs/taxation/> company\_tax/common\_tax\_base/index\_en.htm

21 A committee formed by the European Commission, consisting of rep- resentatives of EU Member States and private sector representatives.

22 Available from [http://eur-lex.europa.eu/legal-content/en/TXT/?uri=](http://eur-lex.europa.eu/legal-content/en/TXT/?uri) CELEX%3A52015DC0302

23 UN Centre in Transnational Corporations, “International Income Taxation and Developing Countries” Doc.ST/CTC/56 (1988).

24 Available from [http://unctad.org/en/pages/PublicationArchive.aspx?](http://unctad.org/en/pages/PublicationArchive.aspx) publicationid=348

* + - 1. The United Nations is again taking a leadership role, through this Transfer Pricing Manual, in trying to arrive at updated global transfer pricing guidance which can be used by countries all over the world in developing and implementing their transfer pricing regulations.

## B .1 .4 . Concepts in Transfer Pricing

* + - 1. The UN Model Tax Convention Article 9(1) states the following

“Where:

* + - * 1. 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
        2. 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 rela- tions 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”*.***25**

* + - 1. In other words, the transactions between two related parties must be based on the arm’s length principle (ALP). The term “arm’s length principle” itself is not a term specifically used in Article 9, but is well accepted by countries as encapsulating the approach taken in Article 9,**26** with some differing interpretations as to what this means in practice. The principle set out above in the UN Model

25 United Nations, New York 2011. Available from <http://www.un.org/> esa/ffd/documents/UN\_Model\_2011\_Update.pdf

26 See for example Paragraph 1 of the UN Model and OECD Model Com- mentaries on Article 9.

has also been reiterated in the OECD Model Tax Convention and the OECD Guidelines as supplemented and amended.

* + - 1. The arm’s length principle is thus the accepted guiding principle in establishing an acceptable 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. 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 meas- ure or benchmark for verifying the transfer prices for intra-entity or intra-group transactions and their acceptability for taxation purposes.
      3. 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 intra-group transactions as equivalent to those between independent entities. Under the arm’s length principle, intra-group transactions are tested and may be adjusted if the trans- fer prices are found to deviate from comparable arm’s length transac- tions. The arm’s length principle is argued to be acceptable to everyone concerned as it uses the marketplace as the norm.
      4. An argument in favour of using the arm’s length princi- ple is that it is geographically neutral, as it treats profits from invest- ments 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 the jurisdictions in which an inter- national enterprise operates. In the absence of consistent rules and administration, international enterprises may have an incentive to avoid taxation through transfer pricing manipulation.
      5. While it is relatively easy to describe the arm’s length prin- ciple, establishing guidelines on the practical application of the prin- ciple is a complex task. Practical application of the principle requires identification and application of reliable comparable transactions.
      6. A practical example follows of 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 in Country B to unrelated parties (e.g., the public at large). 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 the public at large, i.e. to unrelated parties, then perhaps Corporation P would have an incentive to book as much profit as possible in Country A and to this end show a very high sales value (or transfer price) of the seats to its Subsidiary S in Country B. If the tax rate was higher in Country A than in Country B, then the corporation would have an incentive to show a very low sales value (or transfer price) of the seats to its Subsidiary S in Country B and concentrate almost the entire profit in the hands of Country B.

This is a clear example 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. 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 between unrelated taxpayers at arm’s length.

* + - 1. Intangibles present a unique challenge to applying the arm’s-length principle to arrive at the appropriate transfer price as in practice they may be tough to identify, value and find comparables for. A whole host of transfer pricing issues has opened up due to the rapid increase in the use of intangibles by MNE’s.
      2. All parties involved, and especially the tax authorities conducting transfer pricing examinations, should be aware that there can be many factors affecting the arm’s length price. These factors range from government policies and regulations to cash-flows of the entities in the MNE group.
      3. 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 to the arm’s length transaction; any such adjustment may arise irrespective of the contractual terms between the entities. Another incorrect assumption, often made in practice, is that the commercial or financial relations between associated enterprises and in the marketplace will without fail be different and always at odds with each other.
      4. In many cases the MNEs themselves may have an incen- tive to set an arm’s length price for their intra-group transactions so as to judge the true performance of their underlying entities.
      5. Overall, the underlying idea behind the arm’s length princi- ple is the attempt to place transactions, both uncontrolled and controlled, on equal terms with respect to the tax advantages (or disadvantages) that they create. The arm’s length principle has been widely accepted and has found its way into most transfer pricing legislation across the world.
      6. An alternative to the arm’s length principle might be a Global Formulary Apportionment Method, which would allocate the global profits of an MNE group amongst 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 apportion- ment approach is currently used by some states of the USA, cantons of Switzerland and provinces of Canada. Also, the Brazilian transfer pricing rules**27** set out a maximum ceiling on the expenses that may be deducted for tax purposes in respect of imports and lay down a mini- mum level for the gross income in relation to exports, effectively using a set formula to allocate income to Brazil. The EU is also consider- ing a formulary approach, at the option of taxpayers, to harmonize its corporate taxes under the Common Consolidated Corporate Tax Base (CCCTB) initiative.

## Applying the arm’s length principle

* + - 1. The process to arrive at the appropriate arm’s length price typically involves the following processes or steps:

27 See the Brazilian approach outlined at Chapter D.1.

* 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.
  + - 1. The above processes are discussed in detail in Chapter B.2 of this Manual on Comparability Analysis.
      2. The transfer pricing methods are set forth in more detail at B.1.5. below, and are dealt with comprehensively at Chapter B.3. 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.
      3. 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.

## B .1 .5 . Transfer Pricing Methods

* + - 1. The key question is how to apply the arm’s length principle in practice to determine the arm’s length price of a transaction. Several acceptable transfer pricing methods exist, providing a conceptual framework for the determination of the arm’s length price. No single method is considered suitable in every situation and the taxpayer must select the method that provides the best estimate of an arm’s length price for the transaction in question.
      2. All these transfer pricing methods rely directly or indi- rectly on the comparable profit, price or margin information of similar transactions. This information may be an “internal comparable” based

on similar uncontrolled transactions between the entity and a third party or an “external comparable” involving independent enterprises in the same market or industry.

* + - 1. The six major transfer pricing methods (discussed in detail at Chapter B.3. of this Manual) are as follows:

## Transaction-based methods

* + - 1. **Comparable Uncontrolled Price (CUP)** The CUP Method compares the price charged for a property or service transferred in a controlled transaction to the price charged for a comparable prop- erty or service transferred in a comparable uncontrolled transaction in comparable circumstances.
      2. **Resale Price Method (RPM)** The Resale Price Method is used to determine the price to be paid by a reseller for a product purchased from an associated enterprise and resold to an independ- ent enterprise. The purchase price is set so that the margin earned by the reseller is sufficient to allow it to cover its selling and operating expenses and make an appropriate profit.
      3. **Cost Plus (C+ or CP)** The Cost Plus Method is used to determine the appropriate price to be charged by a supplier of property or services to a related purchaser. The price is determined by adding to costs incurred by the supplier an appropriate gross margin so that the supplier will make an appropriate profit in the light of market condi- tions and functions performed.

## Profit-based methods

* + - 1. Two classes of transactional profit methods are recog- nized by the US Section 482 IRS regulations and the OECD Guidelines. These may be categorized as *profit-comparison methods* (Transactional Net Margin Method or TNMM/Comparable Profits Method or CPM) and *profit-split methods*.
      2. **Profit comparison methods (TNMM/CPM) .** These methods seek to determine the level of profits that would have resulted from controlled transactions by reference to the return realized by the comparable independent enterprise. The TNMM determines the net profit margin relative to an appropriate base realized from the

controlled transactions by reference to the net profit margin relative to the same appropriate base realized from uncontrolled transactions.

* + - 1. **Profit-split methods .** Profit-split methods take the combined profits earned by two related parties from one or a series of transactions and then divide those profits using an economically valid defined basis that aims at replicating the division of profits that would have been anticipated in an agreement made at arm’s length. Arm’s length pricing is therefore derived for both parties by working back from profit to price.
      2. **Sixth method (Commodity Rule) .** The Commodity Rule, also known as the ‘sixth method’ is especially applicable to commod- ity transactions. It is in use, with many variations thereof, by several developing countries for arriving at the arm’s-length price of import and export transactions of commodities such as grains, oil and oilseeds, oil and gas, mining and fishing.
      3. The workings of the Commodity Rule may resemble the Comparable Uncontrolled Price (CUP) method. The fact pattern addressed by this method is, for example, where one of the associated enterprises engaged in exporting commodities invoices an associated enterprise in relation to the sale of the commodities though it ships the commodities to a party (and jurisdiction) different from the associated enterprise that it (the seller) invoiced. Furthermore, the actual ship- ment date is usually at a later point in time than date of the original sale between the associated enterprises and the intercompany invoice date. Typically, the associated enterprise being invoiced is a trading entity that carries title to the shipped goods for a limited period of time and the subsequent shipment is to a destination determined by a third party that has bought the commodities from the associated trader (not to the residence of the associated trading entity). There are a number of permutations of this Commodity Rule observed in prac- tice related to different aspects that make up the rule. Chapter B.3. deals with this sixth method, namely the Commodity Rule, in detail.
      4. The first three methods above (i.e. CUP, RPM and CM) are often called “traditional transaction” methods and the last two are called “transactional profit methods” or “profit-based” methods. As noted above, there is growing acceptance of the practical importance of the profit-based methods. All these methods are widely accepted by national

tax authorities. It must be noted that the US regulations provide for the use of additional methods applicable to global dealing operations like the Comparable Uncontrolled Transaction (CUT) Method. This method is similar to the CUP in that it determines an arm’s length royalty rate for an intangible by comparison to uncontrolled transfers of compara- ble intangible property in comparable circumstances.

* + - 1. Other unspecified methods may be used to evaluate whether the amount charged in a controlled transaction is at arm’s length. Any such method should be applied in accordance with the reliability considerations used to apply the specified methods described above. An unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. In establishing whether a controlled transaction achieves an arm’s length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled trans- action. These methods are discussed in detail at Chapter B.3.

## B .1 .6 . Special Issues Related to Transfer Pricing

**Documentation requirements**

* + - 1. Generally, a transfer pricing exercise involves various steps such as:
         * Gathering background information;
         * Industry analysis;
         * Comparability analysis (which includes functional analysis);
         * Selection of the method for determining arm’s length pricing; and
         * Determination of the arm’s length price.
      2. At every stage of the transfer pricing process, vary- ing degrees of documentation are necessary, such as information on contemporaneous transactions. One pressing concern regard- ing transfer pricing documentation is the risk of overburdening the taxpayer with disproportionately high costs in obtaining relevant

documentation or in an exhaustive search for comparables that may not exist. Ideally, the taxpayer should not be expected to provide more documentation than is objectively required for a reasonable deter- mination by the tax authorities of whether or not the taxpayer has complied with the arm’s length principle. Cumbersome documenta- tion demands may affect how a country is viewed as an investment destination and may have particularly discouraging effects on small and medium-sized enterprises (SMEs).

* + - 1. Broadly, the information or documents that the taxpayer needs to provide can be classified as:

enterprise-related documents (for example the ownership/sharehold- ing pattern of the taxpayer, the business profile of the MNE, industry profile etc.);

transaction-specific documents (for example the details of each inter- national transaction, functional analysis of the taxpayer and associated enterprises, record of uncontrolled transactions for each international transaction etc.); and

computation-related documents (for example the nature of each inter- national transaction and the rationale for selecting the transfer pricing method for each international transaction, computation of the arm’s length price, factors and assumptions influencing the determination of the arm’s length price etc.).

* + - 1. The domestic legislation of some countries may also require “contemporaneous documentation”. Such countries may consider defining the term “contemporaneous” in their domestic legislation. The term “contemporaneous” means “existing or occur- ring in the same period of time”. Different countries have different views about how the word “contemporaneous” is to be interpreted with respect to transfer pricing documentation. Some believe that it refers to using comparables that are contemporaneous with the trans- action, regardless of when the documentation is produced or when the comparables are obtained. Other countries interpret contemporane- ous to mean using only those comparables *available* at the time the transaction occurs.
      2. An important development in the documentation require- ments for transfer pricing purposes is the recent effort to establish a

uniform documentation standard. In connection with this, in 2015, the OECD/G20 BEPS Project issued guidance which set out a stand- ardized three-tier approach to transfer pricing documentation. It suggests that the documentation should include (i) a Master File containing general information about the MNE group relevant to all MNE group members; (ii) a Local File referring specifically to material transactions of the MNE group members resident in the local jurisdic- tion and setting out the taxpayer’s transfer pricing methodology and

(iii) a Country-by-Country- Report (“CbC Report”) containing infor- mation relating to global allocation among the MNE’s taxing juris- dictions and taxes paid along with economic activity indicators in the MNE group. The Final BEPS Report included agreed guidance on implementing the new documentation and reporting rules. See further Chapter C.2.

* + - 1. These OECD/G20 BEPS guidelines relating to documenta- tion cannot be automatically assumed to be adopted in full by devel- oping countries. The guidelines have to be analyzed as to how in practice they may be applicable in a developing country context and the constraints that may exist in the MNE and the tax administrations in developing countries have to be kept in mind. Developing countries may, however, assume that in future MNEs generally will prepare the Master File, and that the largest MNEs will additionally prepare the CbC Report. The key question for developing countries would likely be whether the Local File envisioned in these BEPS guidelines should be adopted without modification in the country.

## Intangibles

* + - 1. Intangibles (literally meaning assets that cannot be touched) encompass something which is neither a physical nor a finan- cial asset, which is capable of being owned or controlled for commer- cial purposes, whose use or transfer would be compensated had it occurred between independent enterprises in comparable circum- stances. This definition is the same as that in the OECD/G20 BEPS Action Plan 8 Report, which looks at transfer pricing issues involving intangibles.
      2. A common distinction is made between legally registered and non-registered intangibles. Another category of intangibles is

that of ‘soft’ intangibles, which refer to items such as network effects, internal procedures and best practices that may not be legally regis- tered and may not be separately traded between third parties though they might form a key part of the success or failure of companies in competitive markets.

* + - 1. For the purpose of transfer pricing issues, intangibles are typically divided into “trade intangibles” and “marketing intangibles”. Trade intangibles such as know-how relate to the production of goods and the provision of services and are typically developed through research and development. Marketing intangibles refer to intangi- bles such as trade names, trademarks and client lists that aid in the commercial exploitation of a product or service.
      2. For transfer pricing, whether a particular intangible is ‘unique and valuable’ is an important, separate concept and is meas- ured by whether such intangible is not present in otherwise compa- rable uncontrolled transactions and whether it leads to significant expected premium value in business operations
      3. There are many types of intangibles — including “market features” i.e. specific non-local characteristics of a certain market which may affect arm’s-length, “goodwill” or “ongoing concern value”, “group synergies”, existence of a qualified and skilled “work- force” which may all meet the criteria of being considered an intangi- ble depending on the facts and circumstances of the case.
      4. The analysis of transactions involving intangibles is thus quite complicated and typically, at the fact-finding phase itself, one must consider the development (or else acquisition from third-parties) of the intangibles, the enhancement, maintenance, protection and exploitation of intangibles — together collectively known as “DAEMPE” contributions.
      5. The legal ownership and contractual terms also form the basis for analysis of intangibles, and their transfer, between associated enterprises. Legal ownership of intangibles does not by itself confer a right to ultimately retain returns derived at MNE level. What is relevant for transfer pricing is to determine with accuracy the valuable contri- butions by the associated enterprises in terms of functions performed, risks assumed and assets utilized in the context of value creation.
      6. Further, the question of who should bear the difference between *ex ante* returns and actual *ex post* returns depends on the extent to which the relevant risk is assumed by the parties and requires proper delineation of the transaction involving intangibles.
      7. It suffices to say that the arm’s length principle often becomes very difficult to apply to intangibles. The multitude of issues involved in the transfer pricing of transactions involving intangibles has been dealt with in detail in Chapter B.5, of this Manual.
      8. The Profit Split Method is typically used in cases where both parties to the transaction make unique and valuable contribu- tions. However, care should be taken to identify the intangibles in ques- tion. Experience has shown that the transfer pricing methods most likely to prove useful in matters involving transfers of intangibles or rights in intangibles are the CUP Method and the Transactional Profit Split Method. Valuation techniques can be useful tools in some circumstances.

## Business restructuring

* + - 1. There is no universally accepted definition for business restructuring but in the transfer pricing scenario, it is considered to be cross-border redeployment of functions, assets and risks to which a profit/loss potential may be attached. Business restructuring has a very wide ambit; typically, it may concern the conversion of local full-fledged manufacturers into contract manufacturers; the adoption of a limited-risk distribution structure by a distributor; or the transfer of intangibles to principal companies abroad.
      2. The general rule is that businesses may organize their activities in the manner they see fit. The key issue becomes whether such restructuring is undertaken in a manner consistent with the arm’s-length principle.
      3. For developing countries, it is important to ensure that the arm’s-length principle is applied neutrally i.e. not distinguishing whether one of the entities in the restructuring is in a developing coun- try. There might be implementation issues with respect to the lack of comparables in a developing country but that should not affect the fact that the transfer pricing effects of a business restructuring should be the same regardless of where the reorganization actually takes place.
      4. Chapter B.7 deals with the various aspects of the transfer pricing of business restructurings in more detail.

## Intra-group services

* + - 1. An intra-group service, as the name suggests, is a service provided by one enterprise to another in the same MNE group. For a service to be considered an intra-group service it must be similar to a service which an independent enterprise in comparable circum- stances would be willing to pay for in-house or else perform by itself. If not, the activity should not be considered as an intra-group service under the arm’s length principle. The rationale is that if specific group members do not need the activity and would not be willing to pay for it if they were independent, the activity cannot justify a payment. Further, any incidental benefit gained solely by being a member of an MNE group, without any specific services provided or performed, should be ignored.
      2. In the case of centralized services, each associated enter- prise within the MNE group receiving a benefit from a centralized service has to be charged at the arm’s length price for the services. These centralized services may be part of an associated enterprise’s main business activity or it may be low-margin services, for exam- ple administrative services. Different charging methods may be used appropriately for such low and high-margin services.
      3. An arm’s length price for intra-group services may be determined directly or indirectly — in the case of a direct charge, the CUP Method could be used if comparable services are provided in the open market. In the absence of comparable services, the Cost Plus Method could be appropriate.
      4. If a direct charge method is difficult to apply, the MNE may apply the charge indirectly by cost sharing, by incorporating a service charge or by not charging at all. Such methods would usually be accepted by the tax authorities only if the charges are supported by foreseeable benefits for the recipients of the services, the methods are based on sound accounting and commercial principles and they are capable of producing charges or allocations that are commensurate with the reasonably expected benefits to the recipient. In addition, tax authorities might allow a fixed charge on intra-group services under

safe harbour rules or a presumptive taxation regime, for instance where it is not practical to calculate an arm’s length price for the performance of services and tax accordingly.

* + - 1. A separate chapter, Chapter B.4 deals with the issues related to intra-group services.

## Cost-contribution agreements

* + - 1. Cost-contribution agreements (CCAs) may be formu- lated among group entities to jointly develop, produce or obtain rights, assets or services. Each participant bears a share of the costs and in return is expected to receive *pro rata* (i.e. proportionate) benefits from the developed property without further payment. Such arrangements tend to involve research and development or services such as central- ized management, advertising campaigns etc.
      2. In a CCA there is not always a benefit that ultimately arises; only an expected benefit during the course of the CCA which may or may not ultimately materialize. The interest of each participant should be agreed upon at the outset. The contributions are required to be consistent with the amount an independent enterprise would have contributed under comparable circumstances, given these expected benefits. The CCA is not a transfer pricing method; it is a contract. However, it may have transfer pricing consequences and therefore needs to comply with the arm’s length principle.
      3. A CCA will fail the arm’s-length test if the contributions of the participants are inconsistent with their share of expected bene- fits. If a participant’s share of the benefits is inadequate in comparison to its contribution, a tax authority may make an adjustment to rectify the imbalance. In certain cases, the CCA terms might differ from the economic reality of a CCA and the entire CCA, or some terms thereof, may be disregarded by a tax authority.
      4. A separate chapter, Chapter B.6, deals with the issues related to cost-contribution arrangements.

## Use of “secret comparables”

* + - 1. There is often concern expressed by enterprises over aspects of data collection by tax authorities and its confidentiality.

Tax authorities need to have access to very sensitive and highly confi- dential information about taxpayers, such as data relating to margins, profitability, business contacts and contracts. Confidence in the tax system means that this information needs to be treated very carefully, especially as it may reveal sensitive business information about that taxpayer’s profitability, business strategies and so forth.

* + - 1. Using a secret comparable generally means the use of information or data about a taxpayer by the tax authorities to form the basis of risk assessment or a transfer pricing audit of another taxpayer. That second taxpayer is often not given access to that information as it may reveal confidential information about a competitor’s operations.
      2. Caution should be exercised in permitting the use of secret comparables in the transfer pricing audit unless the tax author- ities are able to (within limits of confidentiality) disclose the data to the taxpayer so as to assist the taxpayer to defend itself against an adjustment. Taxpayers may otherwise contend that the use of such secret information is against the basic principles of equity, as they are required to benchmark controlled transactions with comparables not available to them — without the opportunity to question comparabil- ity or argue that adjustments are needed.

## B .1 .7 . Transfer Pricing in Domestic Law

**Introduction**

* + - 1. Article 9 (“Associated Enterprises”) of tax treaties typi- cally only regulates the basic conditions for adjustment of transfer pricing and corresponding adjustments in case of double taxation. The Article advises the application of the arm’s length principle but does not go into the particulars of transfer pricing rules. It is generally understood that Article 9 is not “self-executing” as to domestic appli- cation — it does not create a transfer pricing regime in a country where such a regime does not already exist.
      2. It should be recognized that transfer pricing regimes are creatures of domestic law and each country is required to formu- late detailed domestic legislation to implement transfer pricing rules. Many countries have passed such domestic transfer pricing legislation

which typically tends to limit the application of transfer pricing rules to cross-border related party transactions only.

* + - 1. It is important to note that the definition of an “associated enterprise” is based on domestic circumstances and hence varies, to some extent, amongst different countries. For example, a majority of countries employ a hybrid qualification for such taxpayers, namely a mixture of qualification by minimum shareholding (generally equal to or more than 50%) and effective control by any other factors (depend- ency in financial, personnel and trading conditions). *De minimis* crite- ria for the value of related party transactions may also exist. In other words, some transactions may be considered small enough that the costs of compliance and collection do not justify applying the transfer pricing rules, but this should not allow what are in reality larger trans- actions to be split into apparently smaller transactions to avoid the operation of the law.
      2. It must be noted that transfer pricing being essentially domestic regulation has a long history, and international consistency of transfer pricing rules is beneficial not only regarding the basic struc- ture of taxable persons and events but also in the manner of applica- tion of the arm’s length principle. However, it is ultimately for each country to adopt an approach that works in its domestic legal and administrative framework, and is consistent with its treaty obligations.

## Safe harbours

* + - 1. There are countries which have “safe harbour” rules providing that if a taxpayer meets certain criteria it is exempt from the application of a particular rule, or at least exempt from scrutiny as to whether the rule has been met. The intention is to increase taxpayer certainty and reduce taxpayer compliance costs, but also to reduce the administration’s costs of collection, as well as allowing the admin- istration to concentrate scarce audit and other resources on those cases where more is likely to be at stake in terms of non-compliance and revenue.
      2. Safe harbour rules are provisions whereby if a taxpayer’s reported profits are within a certain range or percentage or under a certain amount, the taxpayer is not required to follow a complex and burdensome rule, such as applying the transfer price methodologies.

They may only be used by the taxpayers at their option. There are some risks to safe harbours, such as arbitrariness in setting parame- ters and range; equity and uniformity issues; incompatibility with the arm’s length principle; opportunities for tax planning and tax evasion and potential risk of double taxation. In any case, consistent with the purpose of this Manual, introducing a safe harbour rule should involve analysis of whether, in a broad sense, the administrative and simplifi- cation benefits of a safe harbour outweigh the potential costs of apply- ing something other than the arm’s length principle.

## Controlled foreign corporation provisions

* + - 1. Some countries operate 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 and “parking” income there. CFC rules treat this income as though it has been repat- riated and it is therefore taxable prior to actual repatriation. Where there are CFC rules in addition to transfer pricing rules, an important question arises as to which rules have priority in adjusting the taxpay- er’s returns. Due to the fact that the transfer pricing rules assume all transactions are originally conducted under the arm’s length principle, it is widely considered that transfer pricing rules should have priority in application over CFC rules. After the application of transfer pric- ing rules, countries can apply the CFC rules on the retained profits of foreign subsidiaries.

## Thin capitalization

* + - 1. Domestic tax laws in many countries consider a company to be “thinly capitalized” when there is a much greater proportionate contribution of debt than of equity in its capital. This is because it may be sometimes more advantageous from a tax viewpoint to finance a company by way of debt (i.e., leveraging) rather than by way of equity contributions as typically the payment of interest on the debts may be deducted for tax purposes whereas distributions are non-deductible dividends. To prevent tax avoidance by such excessive leveraging, many countries have introduced rules to prevent thin capitalization, typically by prescribing a maximum debt to equity ratio. Country tax adminis- trations often introduce rules that place a limit on the amount of interest

that can be deducted in calculating the measure of a company’s profit for tax purposes. Such rules are designed to counter cross-border shift- ing of profit through excessive debt, and thus aim to protect a country’s tax base. From a policy perspective, failure to tackle excessive interest payments to associated enterprises gives MNEs an advantage over purely domestic businesses which are unable to gain such tax advantages.

## Documentation

* + - 1. Another important issue for implementing domestic laws is the documentation requirement associated with transfer pricing. Tax authorities need a variety of business documents which support the application of the arm’s length principle by specified taxpay- ers. However, there is some divergence of legislation in terms of the nature of documents required, penalties imposed, and the degree of the examiners’ authority to collect information when taxpayers fail to produce such documents. There is also the issue of whether documen- tation needs to be “contemporaneous”, as noted above.
      2. In deciding on the requirements for such documenta- tion there needs to be, as already noted, recognition of the compliance costs imposed on taxpayers required to produce the documenta- tion. Another issue is whether the benefits, if any, of the documen- tation requirements from the administration’s view in dealing with a potentially small number of non-compliant taxpayers are justified by a burden placed on taxpayers generally. A useful principle to bear in mind would be that the widely accepted international approach which takes into account compliance costs for taxpayers should be followed, unless a departure from this approach can be clearly and openly justi- fied because of local conditions which cannot be changed immediately (e.g. constitutional requirements or other overriding legal require- ments). In other cases, there is great benefit for all in taking a widely accepted approach. See further Chapter C.2 of this Manual which details the most widely accepted approaches.

## Advance pricing agreements

* + - 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. These APAs are so named because pricing methodologies are agreed in advance in rela- tion to certain types of transactions, often called the “covered transac- tions”. APAs provide greater certainty for the taxpayer on the taxation of certain cross-border transactions and are considered by the taxpay- ers as the safest way to avoid double taxation, especially where they are bilateral or multilateral. Many countries have introduced APA proce- dures in their domestic laws though these may have different legal forms. For example, in certain countries an APA may be a legally bind- ing engagement between taxpayers and tax authorities, while in other countries it may be a more informal arrangement between the tax authorities and the taxpayer. The possible advantages and disadvan- tages of APAs for developing country administrations and taxpayers, including some implementation issues, are addressed in Chapter C.4.

## Time limitations

* + - 1. Another important point for transfer pricing domes- tic legislation is the “statute of limitations” issue — the time allowed in domestic law for the tax administration to complete transfer pric- ing audits, make necessary assessments, etc. 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.

## Domestic transfer pricing rules and tax treaties

* + - 1. Both developed and developing countries need to have domestic transfer pricing rules to counter transfer pricing manipu- lation and also need the “associated enterprises” article of tax treaties (usually Article 9) which is relevant to avoidance and elimination of double taxation due to transfer pricing adjustments. One view is that the associated enterprises article of a tax treaty provides a separate and independent domestic basis for making transfer pricing adjustments.

The contrary view is that tax treaties do not increase a country’s tax jurisdiction and consequently the associated enterprises article of a country’s tax treaties cannot provide a separate source of tax jurisdic- tion. The detail in such domestic laws will vary from country to coun- try and will often vary depending on how advanced the country is in its transfer pricing journey.

* + - 1. One view is that a country’s tax jurisdiction, usually some mixture of residence and source-based taxation, is based on its domes- tic legislation; when two countries enter into a tax treaty with each other they agree to mutually modify the exercise of their respective taxing rights to prevent double taxation. A tax treaty is, in this view, a mechanism to allocate the taxing rights to prevent double taxation arising from the overlap of residence and source jurisdiction. Tax trea- ties operate by altering the operation of domestic tax law; by either excluding the operation of the domestic tax law of a treaty country or by requiring a treaty country to provide a credit against its domes- tic tax for tax paid in the other treaty country. The generally held view is that a tax obligation under a tax treaty exists if the requirements of the treaty country’s domestic law and the tax treaty are both satisfied. The taxing powers of each treaty country are based on their respec- tive domestic taxation law and may be limited but not expanded by the treaty. Also, treaties do not provide the necessary detail on how a transfer pricing regime will work in practice, such as the documenta- tion required. As a consequence of these factors, it is generally consid- ered that a country with tax treaties should enact domestic transfer pricing measures rather than asserting that its treaties provide it with a power to make transfer pricing adjustments.
      2. For transfer pricing measures to be effective, a jurisdiction must enforce them and ensure that taxpayers comply with the rules. If jurisdictions either do not enact transfer pricing measures or do not enforce those measures there is an incentive for taxpayers to ensure that intra-group transfer prices favour jurisdictions that enforce their rules. This may be described as taking the line of least resistance, but it does provide an incentive for developing jurisdictions to enact and enforce some form of transfer pricing rules to protect their revenue base.
      3. That MNEs might use transfer prices to shift profits from lower tax countries to higher tax countries is a paradox, but happens

in practice (e.g. to benefit from certain tax incentives in the high tax country or because there are losses in the high tax country that can be offset with profits from a lower tax country). MNEs may also have an incentive to shift profits to jurisdictions in which tax laws, such as transfer pricing rules, are not enforced. Transfer pricing is a “zero sum game” — a situation in which the “gain” of taxable profits by one jurisdiction must be matched by a “loss” by the other jurisdiction. Consequently, some international enterprises might set their transfer prices to favour a jurisdiction expected to enforce its transfer pricing rules, in order to minimize the risk of transfer pricing adjustments and penalties in that jurisdiction. Moreover, transfer pricing disputes are generally time consuming and expensive.

## B .1 .8 . Transfer Pricing in Treaties

**UN and OECD Model Conventions: An overview**

* + - 1. The OECD Model Convention**28** was first published in 1963 as a draft version. A final version was first published in 1977. This OECD work followed up some work already done by the League of Nations; and then after World War II by the United Nations. The United Nations produced a UN Model Convention for Treaties between Developed and Developing Nations in 1980, with updates in 2001 and 2011.**29** The UN Model Convention was most recently updated in 2017.**30** The UN Model is in many respects similar to the OECD Model but the differences (such as preserving greater taxation rights to coun- tries hosting investments) are very significant, especially for develop- ing countries.
      2. There has historically been a widespread view that the OECD Model was most appropriate for negotiations between devel- oped countries and less suitable for capital importing or developing

28 A read-only but downloadable version of the OECD Model is available from <http://www.oecd.org/tax/treaties/oecdmtcavailableproducts.htm>

29 Available from <http://www.un.org/esa/ffd/documents/UN_Model_2011>

\_Update.pdf

30 Available from <http://www.un.org/esa/ffd/documents/publications/pub> lications-tax-committee.html

countries. In general, it can be said that the UN Model preserves more taxation rights to the source state (i.e. host state of investment) or capital-importing country than the OECD Model. The UN Model has been embraced by many developing states as the basis of their treaty policy. Some developed countries also adopt some UN Model provi- sions, and at times it has influenced changes to give aspects of the OECD Model a greater source country orientation.

## Transfer pricing and the model conventions

* + - 1. Article 9 of the OECD Model is a statement of the arm’s length principle and allows for profit adjustments if the actual price or the conditions of transactions between associated enterprises differ from the price or conditions that would be charged by inde- pendent enterprises under normal market commercial terms, i.e. an arm’s length basis. It also requires that an appropriate “corresponding adjustment” be made by the other Contracting State in such cases to avoid economic double taxation, taxation of essentially the same profit in the hands of two different legal entities if justified in principle and in amount. In other words, if one country increases the profit attrib- uted to one side of the transaction, the other country should reduce the profit attributed to the other side of the transaction. The competent authorities**31** of the Contracting States are if necessary to consult with each other in determining the adjustment.
      2. Other OECD Model Tax Convention articles which apply the arm’s length principle include the article concerning dealings between the head office and a permanent establishment (Article 7(2)). Article 7(4) previously explicitly permitted the use of the apportionment of total profit by countries customarily using it, provided the result was consistent with the arm’s length principle, but this has been removed from the latest (2010) version of the OECD Model in a major re-write of Article 7.
      3. The UN Model contains similar provisions to the OECD Model in Article 9 (at Paragraph 1 especially) and therefore serves as a guide for applying the arm’s length principle for developing countries.

31 Officials designated by countries to discuss treaty and other interna- tional tax-related issues with each other.

However, the UN Model also includes an additional paragraph (Article 9(3)) which stipulates that a Contracting State is not required to make the corresponding adjustment referred to in Article 9(2) where judi- cial, 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 willful default.

* + - 1. There is some ambiguity in the concept of “associated enterprises” in the context of the Model Conventions; e.g. the term is used in the heading of Article 9, but not in the text. The Model Conventions use the concept to cover relationships between enter- prises which are sufficiently close to require the application of transfer pricing rules. Concepts such as “management”, “capital” and “control” are often defined under the domestic law in many countries and may be extended for transfer pricing. E.g., if parties to the transaction make arrangements differing from those made by unrelated parties this could be considered to lead to a situation of “control”. Also, some- times a wider definition including both *de jure* (i.e. according to legal form) and *de facto* (i.e. according to practical reality) control, which are difficult to define, may be adopted based on the anti-avoidance provisions in domestic law.
      2. The Model Conventions also spell out in Article 25 a key transfer pricing dispute resolution mechanism — the Mutual Agreement Procedure (MAP). The MAP facilitates the settlement of disputes on corresponding adjustments among competent authorities. It should be noted that the MAP procedure does not guarantee relief as it is voluntary; there is, however, a duty to negotiate in good faith to try to achieve a result consistent with the treaty allocation of taxing rights. Chapter C.4 discusses the MAP in more detail.
      3. Finally, there are a small number of bilateral treaties which allow for arbitration to resolve transfer pricing disputes.**32** Further, the EU Arbitration Convention**33** establishes a procedure to resolve

32 A paragraph relating to arbitration has also been included in Article 25 of the OECD Model Tax Convention.

33 Convention 90/436/EEC 1990 available at <http://eur-lex.europa.eu/> LexUriServ/LexUriServ.do?uri=CELEX:41990A0436:en:HTML See also the

disputes where double taxation occurs between enterprises of different Member States in the EU as a result of an upward adjustment of prof- its of an enterprise of one Member State.

* + - 1. Overall, the Model Conventions are a critical source of acceptance for the arm’s length principle. Given that many countries around the world follow fairly closely one of the Model Conventions, the arm’s length principle has been widely accepted, even though its imperfections are also widely recognized.

### Relevance of UN and OECD Model and the OECD Guidelines to developing countries

* + - 1. Transfer pricing rules have been developed mainly by the members of the OECD (i.e. developed countries) because of their historical and economic backgrounds. Many developing countries currently face some of the same conditions as the OECD countries did in the period from the 1970s to the 1990s. It is therefore useful to focus on certain key areas where many developing countries are encounter- ing difficulties with administering the arm’s length principle.
      2. Developing countries often have substantial problems with the availability of comparable transactions. This issue is consid- ered more fully in Chapter B.2; it suffices to note that due to a typi- cally small domestic market in many developing countries, third party transactions comparable to the MNE’s intra-group transactions are rarely discovered in the home market.
      3. Documentation requirements should as far as possible be common between the two Models (UN and OECD), because diver- sity in documentation rules results in excessive compliance costs for MNEs and smaller enterprises. Targeted documentation requirements can be an alternative to full scale documentation where transactions are simple and the tax at issue is not large. This may be especially important in responding to the needs and capabilities of small and medium-sized enterprises (SMEs).

updated European Commission explanation at https://ec.europa.eu/taxa- tion\_customs/business/company-tax/transfer-pricing-eu-context/transfer- pricing-arbitration-convention\_en

## B .1 .9 . Global Transfer Pricing Regimes

B.1.9.1. The UN and OECD Model Conventions, the OECD Guide- lines and domestic legislation of various countries have provided examples for introduction of transfer pricing legislation worldwide, as a response to the increasing globalization of business and the concern that this may be abused to the detriment of countries without such legislation. Many other countries depend on anti-avoidance rules to deal with the most abusive forms of transfer pricing; see further Part

B.8 on the General Legal Environment concerning legislative design principles for a transfer pricing regime.

## B .1 .10 . Transfer Pricing as a Current and Future Issue

**General issues with transfer pricing**

* + - 1. Several issues arise when applying the arm’s length princi- ple to the domestic realities of developing countries. The high level of integration of international enterprises, the proliferation of intra-group trading in intangibles and services and the use of sophisticated financ- ing arrangements have increasingly made the arm’s length principle difficult to apply in practice.
      2. Increasing globalization, sophisticated communication systems and information technology allow an MNE to control the operations of its various subsidiaries from one or two locations world- wide. 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 the arm’s length principle presents real challenges in allocating the income of highly integrated international enterprises.
      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 taxpay- ers and tax authorities. In view of the skill, information and resource “gaps” in many developing countries, this can be very difficult for those developing countries; the task often requires the best officials, who

may leave the tax department after acquiring their special skills. The intention of this Manual is to play a part in reducing those gaps.

## Transfer pricing and developing countries

* + - 1. For all countries, but particularly for many developing countries, equipping an administration to deal fairly and effectively with transfer pricing issues seems to be a “taxing exercise”, both liter- ally and figuratively.
      2. Some of the specific challenges that many developing countries particularly face in dealing effectively with transfer pric- ing issues (and which will be dealt with in more detail later in this Manual) are listed below.

## Lack of comparables

* + - 1. One of the foundations of the arm’s length principle is examining the pricing of comparable transactions. Proper compa- rability 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 the traditional transfer pricing methods (CUP, RPM and CP) directly rely on comparables. These comparables have to be close in order to be of use for the transfer pricing analysis. 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; so 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 an independent enterprise 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 usu- ally 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” compa- nies who have come into existence in many of the sectors and areas hitherto unexploited or unexplored; in such cases there would be an inevitable lack of comparables.
      2. Given these issues, critics of the current transfer pric- ing methods equate finding a satisfactory comparable to finding a needle in a haystack. Overall, it is quite clear that finding appropri- ate 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 jointly produced by the IMF, OECD, UN and World Bank**34** provides additional guidance on this issue. Chapter B.2 of this Manual provides analysis and practical examples on Comparability Analysis.

## Lack of knowledge and requisite skill-sets

* + - 1. Transfer pricing methods are 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. Their transfer pricing regula- tions have, however, helped some developing countries in creating requi- site skill sets and building capacity, while also protecting their tax base.

## Complexity

* + - 1. Rules based on the arm’s length principle are becoming increasingly difficult and complex to administer. Transfer pricing

34 IMF/OECD/UN/WBG (2017) *Discussion Draft: A Toolkit for Address- ing Difficulties in Accessing Comparable Data for Transfer Pricing Analyzes,* available from https://[www.oecd.org/tax/discussion-draft-a-toolkit-for-add](http://www.oecd.org/tax/discussion-draft-a-toolkit-for-add) ressing-difficulties-in-accessing-comparables-data-for-transfer-pricing- analyzes.pdf

compliance may involve expensive databases and the associated exper- tise 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.

* + - 1. In developing countries resources, monetary and other- wise, may be limited for the taxpayer (especially small and medium sized enterprises (SMEs)) that have to prepare detailed and complex transfer pricing reports and comply with the transfer pricing regu- lations, and these resources may have to be “bought-in”. Similarly, the tax authorities of many developing countries do not have suffi- cient 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. Transfer pricing audits also tend to be a long, time consuming process which may be conten- tious and may ultimately result in “estimates” fraught with conflicting interpretations.
      2. In case of disputes *between* the revenue authorities of two countries, the currently available prescribed option is the Mutual Agreement Procedure as noted above. This too can possibly 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 developing countries.

## Growth of the digital economy

* + - 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 the Internet and related e-commerce transactions is sometimes problematic and unclear.
      2. From the viewpoint of many countries, it is essential for them to be able to appropriately exercise taxing rights on these intangible-related transactions, such as e-commerce and web-based 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 an equalization levy, to include the virtual world and its work- ings in the ambit of international taxation. In many developing coun- tries, the digital economy currently plays a role as a key growth driver in their economic engine and it is therefore imperative for tax author- ities to tackle transfer pricing issues related to it.

## Location savings

* + - 1. Some countries (usually developing countries) take the view that the economic benefit arising from moving operations to a low-cost jurisdiction, i.e., “location savings”, should accrue to that country where such operations are actually carried out.
      2. Accordingly, the determination of location savings, and their allocation between the group companies (and thus, between the tax authorities of the two countries) has become a key transfer pric- ing issue in the context of developing countries. Unfortunately, most international guidelines do not provide much guidance on this issue of location savings, though they sometimes do recognize geographic conditions and ownership of intangibles. The US Section 482 regu- lations provide some sort of limited guidance in the form of recog- nizing that adjustments for significant differences in cost attributable to a geographic location must be based on the impact such differ- ences would have on the controlled transaction price given the rela- tive competitive positions of buyers and sellers in each market. The OECD Guidelines also consider the issue of location savings, empha- sizing that the allocation of the savings depends on what would have been agreed by independent parties in similar circumstances. This issue is dealt with in greater detail later in this Manual. An overview of location savings is provided in Chapter B.2 and some specific coun- try practices on the use of location savings are provided in Part D.

## B .1 .11 . Summary and conclusions

* + - 1. Transfer pricing is generally considered to be the major international taxation issue faced by MNEs today and thus demands significant attention on the part of tax administrations of develop- ing countries. Even though responses to it will in some respects vary, transfer pricing is a complex and constantly evolving area and no government or MNE can afford to ignore it.
      2. Transfer pricing is a difficult challenge for both govern- ments and taxpayers; it tends to involve significant resources, often including some of the most skilled human resources, and costs of compliance. It is often especially difficult to find comparables, even those where some adjustment is needed to apply the transfer pric- ing methods.
      3. The rise of the digital economy has brought to the fore the transfer pricing aspects of ownership, management, use and trans- fer of intangibles which can be highly complex due to the fact that intangibles are typically hard to value while being easy to transfer between parties. The plethora of issues involved in the transfer pricing of intangibles may put an additional burden on the constraints faced by taxpayers and tax authorities in developing countries.
      4. For governments, transfer pricing administration is resource intensive and developing countries often do not have easy access to resources to effectively administer their transfer pricing regulations. In addition, from the government’s perspective, transfer pricing manipulation reduces revenue available for country develop- ment, and with increasing globalization the potential loss of revenue may run into billions of dollars.
      5. Overall, it is a difficult task to simplify the international taxation system, especially transfer pricing, while keeping it equitable and effective for all parties involved. However, a practical approach, such as that proposed by 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 internation- ally coherent, seeking to reduce compliance costs and reduce unre- lieved double taxation.
      6. This chapter aims to introduce the fundamentals of the concepts involved in transfer pricing such as the arm’s length princi- ple and issues related to it. Subsequent chapters will deal with specific transfer pricing concepts in greater detail.

## B .2 . COMPARABILITY ANALYSIS

**B .2 .1 . Rationale for Comparability Analysis**

* + - 1. The term “comparability analysis” is used to designate two distinct but related analytical steps:
         1. An understanding of

The economically significant characteristics and cir- cumstances of the controlled transaction, i.e. the transaction between associated enterprises, and

The respective roles and responsibilities of the parties to the controlled transaction. This is generally per- formed through an examination of five “comparability factors”, see further para. B.2.1.6.

* + - * 1. A comparison between the conditions of the controlled transaction (as established in step 1 immediately above) and those in uncontrolled transactions (i.e. transactions between independent enterprises) taking place in compara- ble circumstances. The latter are often referred to as “com- parable uncontrolled transactions” or “comparables”.
      1. This concept of comparability analysis is used in the selec- tion of the most appropriate transfer pricing method, as well as in applying the selected method to arrive at an arm’s length price or finan- cial indicator (or range of prices or financial indicators). It thus plays a central role in the overall application of the arm’s length principle.
      2. A practical difficulty in applying the arm’s length prin- ciple 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. The mere fact that

a transaction may not be found between independent parties does not of itself mean that it is, or is not, arm’s length.

* + - 1. It should be kept in mind that the lack of a comparable 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 compara- ble economic conditions or comparables from another industry sector. Such a comparable would possibly need to be adjusted to eliminate or reduce the differences between that transaction and the controlled transaction as discussed in Paragraph B.2.1.5 below. 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**35** (see further Chapter B.3.). It may also be necessary to exam- ine 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.
      2. 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 estab- lish the degree of comparability between controlled and uncontrolled transactions. To be comparable does not mean that the two transac- tions are necessarily identical, but instead means that either none of

35 The G20 Development Working Group has requested the development of a Toolkit on this issue. See IMF/OECD/UN/WBG (2017) *Discussion Draft: A Toolkit for Addressing Difficulties in Accessing Comparable Data for Transfer Pricing Analyzes,* available from [https://www.oecd.org/tax/discussion-draft-](https://www.oecd.org/tax/discussion-draft-a-toolkit-for-addressing-difficulties-in-accessing-comparables-data-for-transfer-pricing-analyses.pdf) [a-toolkit-for-addressing-difficulties-in-accessing-comparables-data-for-](https://www.oecd.org/tax/discussion-draft-a-toolkit-for-addressing-difficulties-in-accessing-comparables-data-for-transfer-pricing-analyses.pdf) [transfer-pricing-analyzes.pdf](https://www.oecd.org/tax/discussion-draft-a-toolkit-for-addressing-difficulties-in-accessing-comparables-data-for-transfer-pricing-analyses.pdf)

the differences between them could materially affect the arm’s length price or profit or, where such material differences exist, that reasona- bly accurate adjustments can be made 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 ascer- tained with sufficient accuracy to improve the reliability of the results.

* + - 1. The aforesaid degree of comparability between controlled and uncontrolled transactions is typically determined on the basis of a number of attributes of the transactions or parties that could mate- rially affect prices or profits and the adjustment that can be made to account for differences. An examination of these attributes is therefore necessary to both steps of the comparability analysis. These attributes, which are usually referred to as the five comparability factors, include:
* Characteristics of the property or service transferred;
* Functions performed by the parties taking into account assets employed and risks assumed, in short referred to as the “func- tional analysis”;
* Contractual terms;
* Economic circumstances; and
* Business strategies pursued.
  + - 1. Obviously, as the degree of comparability increases, the number and extent of potential differences that could render the anal- ysis inaccurate necessarily decreases. Also, in general, while adjust- ments can and must be made when evaluating these factors so as to increase comparability, the number, magnitude and the reliability of such adjustments may affect the reliability of the overall comparabil- ity analysis.
      2. The type and attributes of available comparables in a given situation also needs to be considered in determining the most appro- priate transfer pricing method. For further information, see Chapter B.1, Paragraph B.1.5 and Chapter B.3. In general, closely compara- ble products or services are required if the Comparable Uncontrolled Price Method is used for arm’s length pricing; the Resale Price Method,

Cost Plus Method and Transactional Net Margin Method, may also be appropriate where only functional comparables are available, i.e. where the functions performed, assets employed and risks assumed by the parties to the controlled transaction are sufficiently comparable to the functions performed, assets employed and risks assumed by the parties to the uncontrolled transaction so that the comparison makes economic sense. An example would be two comparable distributors of consumer goods of the same industry segment, where the goods distributed may not be exactly the same, but the functional analyzes of the two distributors would be comparable. See further Chapter B.3.

* + - 1. Practical guidance is needed for cases without sufficient comparables. There seem to be two distinct problems relating to comparables for developing countries’ tax authorities. The first is lack of access to existing sources, such as existing non-local company data- bases; the second is the lack of reliable local country comparables. For each of these, there are problems associated with both administration (e.g., how the lack of data impedes the reliable and efficient determina- tion of appropriate arm’s length results) and problems associated with double tax/dispute avoidance (e.g., how the lack of appropriate data impedes a developing country’s ability to reach agreement with other tax authorities, or prevent the developing country from being taken advantage of).
      2. The OECD Transfer Pricing Guidelines point out that non-domestic comparables should not be automatically rejected. The Guidelines further recommend that where independent transactions are scarce in certain markets and industries a pragmatic solution needs to be found on a case by case basis.**36** This means that when the data are insufficient, stakeholders can still use imperfect comparables, after necessary adjustments are made, to assess the arm’s length price. The validity of such procedures depends heavily on the accuracy of the comparability analysis as a whole.
      3. 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

36 OECD, “Transfer Pricing Guidelines for Multinational Enterprises” at Paragraph 3.35 and 3.38.

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).

## B .2 .2 . Comparability Analysis Process

A typical approach that can be followed while performing a compa- rability analysis is outlined below. The steps below are by no means exhaustive but rather suggest an outline based upon which a compara- bility analysis could be carried out. It may be noted that the process is not linear: for example, a number of the steps may need to be carried out repeatedly until a satisfactory result is achieved. The subsequent sections of this chapter deal with each of these steps in more detail:

* Understanding the economically significant characteristics of the industry, taxpayer’s business and controlled transactions

h Gathering of basic information about the taxpayer

h Identifying and accurately delineating the controlled trans- action in question

h Evaluation of separate and/or combined transactions;

* Examination of comparability factors of the controlled transaction

h Characteristics of the property or service transferred

h Functional analysis of the controlled transaction under examination

h Contractual terms of the transaction

h Economic circumstances of the transaction

h Business strategies of the parties;

* Selecting the tested party/ parties (if applicable);
* 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 range of prices or profits);
* Documentation of comparability analysis and monitoring.

## B .2 .3 . Comparability Analysis in Operation

* + - 1. **Understanding the Economically Significant Characteristics of the Industry, Business and Controlled Transactions**

### Gathering of basic information about the taxpayer

* + - * 1. An essential first step to enabling effective transfer pricing analysis is the collection of information about the taxpayer to under- stand its business operations and activities. This fact-finding 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 enterprises (including the func- tions performed, assets used (including intangibles, see Chapter B.5.) and risks assumed, by each party, the nature of products/services transferred, the terms and conditions of the transaction, the economic circumstances, etc.).
        2. An analysis should be performed of the taxpayer’s circum- stances including but not limited to an analysis of the industry, competition, economy, regulatory factors and other elements that may significantly affect the taxpayer and its environment. This analysis is by nature specific to each taxpayer and industry.
        3. Information about the taxpayer from its annual report, product brochures, news articles, research reports prepared by inde- pendent agencies, management letters and internal reports could act as a good starting point for understanding the taxpayer’s circum- stances. A study of these documents will provide an idea of the indus- try 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, type of products/services dealt in, etc.

### Identify the accurately delineated transaction

* + - * 1. The arm’s length price 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 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 former should be taken as the best evidence of the transaction(s) actually undertaken.

* + - * 1. Tax authorities should not substitute other transactions in the place of those that have actually happened and should not disre- gard those transactions actually undertaken 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 a substantive one and looks at the nature of the arrangements entered into: a lack of comparable, independent transactions does not, of itself, indicate that the controlled transaction lacks commercial rationality.
        2. The test for commercial rationality must be considered from each entity’s own perspective, as an arrangement that is commer- cially rational at group level is not necessarily arm’s length from the perspective of each party.
        3. In addition, an arrangement that is expected to leave the MNE group as a whole worse off on a pre-tax basis than it would be if it had not entered into the arrangement will raise the question whether it is primarily tax driven and it may warrant further examination as to whether it is commercially irrational thereby preventing the determi- nation of an arm’s length price for each party to the transaction.
        4. Where a transaction that was actually undertaken is not commercially rational, any alternative transactions that are substi- tuted for transfer pricing purposes should correspond as closely as possible to the actual facts of the case whilst achieving a commercially rational expected result: i.e. one which would have enabled party the parties to come to a price acceptable to both at the time the arrange- ment was entered into.
        5. In general, non-recognition or substitution of transac- tions should not be undertaken lightly as this would create significant

uncertainty for taxpayers and tax administrations; this 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 B.8. and C.5.

### Evaluation of separate and combined transactions

* + - * 1. An important aspect of transfer pricing analysis is whether this analysis has to be carried out with respect to a taxpayer’s individ- ual international controlled transactions or to a group of international controlled transactions having a close economic nexus.
        2. The transfer pricing analysis should ideally be made on a transaction-by-transaction basis. However, there are cases where sepa- rate transactions are so closely linked that such an approach would not lead to a reliable result. Where transactions are so closely interre- lated or continuous that application of the arm’s length principle on a transaction-by-transaction basis would become unreliable or cumber- some, transactions are often aggregated for the purposes of the analysis.
        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, long-term service supply contracts and pricing of closely linked products are difficult to analyze separately.
        4. Another important aspect of combined transactions is the increasing presence of composite contracts and “package deals” in 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 trans- fer price. In certain cases, it may be more reliable to allocate the price to the elements of the composite contract or package deal.

* + - * 1. “Aggregation” issues also arise when looking at poten- tial comparables. Since third party information is not often availa- ble 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 “inter- nal comparable” are defined in Paragraph B.2.3.4.1. 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 pric- ing method to the facts in that particular case.

## Examination of Comparability Factors of the Controlled Transaction

### Overview

* + - * 1. The first part of a comparability analysis for transfer pric- ing 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 the five comparability factors: the charac- teristics of the property or service; contractual terms; functional anal- ysis; economic circumstances and business strategies.

### Characteristics of the property or service transferred

* + - * 1. Property, whether tangible or intangible, as well as services, may have differing characteristics which may lead to a differ- ence 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. Characteristics that may be important to consider are:

In the case of tangible property: physical features, quality, reli- ability, availability and the volume of supply;

In the case of services: nature and extent of such services; 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 commer- cial exploitation (marketing intangibles) as opposed to patents and know-how (trade intangibles).

### Contractual terms of transaction

* + - * 1. The conduct of the contracting parties is generally a result of the terms of the contract between them. The contractual relation- ship thus warrants careful analysis when computing the transfer price. Other than a written contract, the terms of the transactions may 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, the contractual terms have to be deduced from their economic relationship and conduct.
        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 enter- prises, which are expected to hold each other to the terms of the contract. Thus, it is important to figure out whether the contractual terms between the associated enterprises are a “sham” (something that appears genu- ine, 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. 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, deliv- ery terms, credit and payment terms etc. In addition to an examina- tion of these contractual terms, it will be important to check that the actual conduct of the parties conforms to them.
        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.

* + - * 1. 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 sub- sidiary) to ship its product, cocoa beans, from Company A’s Country to overseas markets. Company B occasionally provides transporta- tion 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% of the gross revenues of Company B and the remaining 90% of Company B’s revenues are attributable to the provision of transportation services for cocoa beans to Company A. In determining the degree of comparability between Company B’s uncon- trolled transaction with Company C and its controlled transaction with Company A, the difference in volumes involved in the two transactions, volume discount 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.

### Functional analysis

* + - * 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 of an enterprise. Functional analysis seeks to identify and compare the economically significant activities and the responsibilities undertaken by the independent and the associated enterprises. An economically significant activity is one which materially affects the price charged in a transaction and/or the profits earned from that transaction.
        2. Functional analysis is the cornerstone of any transfer pric- ing exercise; its purpose is to gain an understanding of the operations

of an enterprise with its associated enterprises and of the respective roles of the parties to the controlled transaction under examination. These will affect the determination of an arm’s length remuneration for the 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. Functional analysis is also essential to the identification of potential comparables, as the search for such comparables will generally focus on uncontrolled transactions that present a similar allocation of func- tions, assets and risks between the parties.

* + - * 1. 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 under- taken and the nature of the assets employed by each party. This analy- sis helps to select the tested party/parties where needed (as explained below), the most appropriate transfer pricing method, the compara- bles, and ultimately to determine whether the profits (or losses) earned by the entities are appropriate to the functions performed, assets employed and risks assumed.
        2. The functional analysis is important because the expected return of the entities involved in a transaction depends on the impor- tance of the functions performed, the nature and degree of risks assumed and the nature and value of assets employed. Generally, the more valu- able 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.
        3. A clearer understanding of functional analysis may be gained from an example which can be examined in detail below. Further, hypothetical examples for illustration purposes concerning the different types of international transactions listed below are given with a view to explaining the chapter in a more practical manner. The situations are:

1. Manufacturing of products by XYZ & Co, where the tech- nology is owned by an associated enterprise ABC & Co; and
2. Distribution by A Co of products imported from an associ- ated enterprise B Co for sale in A Co’s country.

Further hypothetical examples for illustration purposes concerning other types of international transactions are provided at Appendix 1 at the end of this Manual with a view to explaining functional analysis in a more practical manner. The situations covered in such examples are that of a manufacturing entity and of a distributor.

**Example: “A Co” — Energy Solutions**

A Co is a company incorporated and registered under the laws of Country

1. A 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. A Co has an established marketing network in many developing and developed countries. A Co is a part of Entity, one of the largest metering consortia in the world, which shares technology and pools the extensive experience of development and manufacture within a network covering over thirty countries.

B Co is a company incorporated and registered under the laws of Country B and is a wholly-owned subsidiary of A Co. B 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, distri- bution and consumption sectors and offers similar 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 B Co in its own R&D facilities.

B Co entered into a license agreement with A Co to source its core tech- nology, TECHNO A™ — developed and patented by A 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 A Co. TECHNO A™ tech- nology 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.

With the above context, the controlled transactions between B Co and A Co are the purchase of certain components and the license of technology from A Co. As noted above, A 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. B Co manufactures energy meters in Country B and uses processors and related components purchased from A Co. B Co then sells energy meters to A Co, in line with its requirements.

B Co has its own R&D centre which tries to improve the technol- ogies 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 B Co has penetrated the market in the territory of Country B by incurring huge marketing expenditure to establish its own marketing intan- gibles. These are separate from the intangibles of A Co in Country A for which a technology license agreement is in place between A Co and B Co.

The following paragraphs describe how functional analysis can be carried out and documented in the example just given involving A Co. For these purposes it is necessary to have a qualitative description of the intra-group transactions and circumstances; this can be repre- sented by the following type of table:

Table B.2.1.:

**Qualitative Assessment of Intra-Group Transactions**

|  |  |  |  |
| --- | --- | --- | --- |
| **Symbol** | **Comparative risk level standards** | **Comparative func- tional 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 |

These symbols are a tool to summarize key aspects of a functional anal- ysis, and to qualitatively compare the different enterprises in a MNE

group across a number of categories related to functions, assets, and risks based solely on the facts of a particular case. This tool, commonly referred to as a “tick chart” is used extensively in this chapter and in Appendix 1. Tick charts, while very useful, are inherently subjec- tive. 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.

* + - * 1. **Functions performed** are the activities that are carried out by each of the parties to the transaction. In conducting a func- tional analysis, economically significant functions are to be consid- ered; 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 identify- ing the maximum number of functions but rather on the identification of critical functions performed by the associated enterprises.
        2. Some of the relevant functions that are generally observed and examined in a transaction are:

Research and development;

Product design and engineering;

Manufacturing, production, process engineering and design work;

Purchasing, materials management and other procurement activities;

Manufacturing, production or assembly work;

Transportation, warehousing and inventory;

Marketing, advertising, publicity and distribution;

Market intelligence on technological developments; and

Intra-group services, for example managerial, legal, accounting and finance, credit and collection, training and personnel man- agement services.

* + - * 1. 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 crea- tion of value depends on the industry and on the taxpayer-specific circumstances. A typical check list is provided in Appendix 1.
        2. 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 rele- vant controlled transaction (e.g. for the producing and selling/distrib- uting activities in this example) to ultimately support the selection of the most appropriate transfer pricing method.
        3. Continuing the example from Paragraph B.2.3.2.12. the following are the functions performed by the respective parties.

### Functions performed by A 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 B Co on the basis of the technological support of A Co, A Co performs the following economically significant functions:

Market development: A Co shares its expertise with B Co and assists in developing presentations to be made by B Co to the utilities (i.e. the bodies responsible for supply of power to the public) for the development of markets.

Product development: A Co undertakes the product develop- ment activities based on the concept developed and offered by it to the users. Product development involves product engineer- ing, designs, development or customization of microprocessors, observance of international standards and national standards for the product etc.

Quality control: A Co undertakes quality control processes in order to ensure that the products manufactured by B 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 B Co:*

It is assumed that, in the purchase of processors and other components by B Co from A Co, the economically significant functions performed by A 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-sales activities including replacements; and

Technical assistance, wherever required.

### Functions performed by B Co

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

***Market development:*** B Co undertakes market development activities. The market development activities primarily include development of the sales concept (i.e. identifying how the com- pany can offer a customized solution to a utility having regard to the specific issues being faced by the utility concerned). B 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 B Co. It also participates in the tendering process to procure full commercial orders for the energy meters once the pilot runs successfully. B Co also carries out activities in

relation to advertisement, appointment of distributors, com- mission agents, sales promotion, market research and market- ing strategies. Also B Co has developed the market for the new product in the territory of Country B by incurring sizeable mar- keting expenditure to establish its own marketing intangibles that are separate from the intangibles of A Co in Country A;

***Research and development:*** B Co has its own R&D centre which tries to boost its performance by improving the technologies so as to achieve further efficiencies, reducing dependence on out- side technologies in future and achieving cost savings.;

***Production scheduling:*** The production by B Co is based on orders obtained from domestic utilities. The procurement pro- cess 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 depart- ment”. 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 B 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 com- ponents, manual inspection of placement of the components, computerized soldering of mounted components, manual inspection of the soldering process, mounting of plasma trans- formed arc components manually, etc.;

***Intelligence loading:*** Intelligence loading refers to the process of loading software and other intelligence features on the man- ufactured meter. B 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. B Co per- forms testing and A Co undertakes quality control measures. Testing activity involves temperature variation testing, testing of manufactured meters against standard meters etc.;

***Packaging and delivery:*** B Co packs the products into specially designed containers of various sizes depending on the con- signment. 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 cus- tomers, B Co undertakes installation and commissioning activi- ties 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 custom- ers. Any replacement or further activities required pursuant to product performance warranties are also undertaken by B Co;

***Inventory management:*** B 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 man- agement is involved.

### General management functions

In the above example the functions addressed below are common functions that are carried out by any business irrespective of its size and type. These functions are drivers of every business and are indis- pensable in the economic environment.

***Corporate strategy determination:*** Generally, all policies within the MNE group are determined by the management of the respective entities which continuously monitor the eco- nomic environment surrounding the entity, assess their strate- gic position within the industry and set targets to achieve their corporate objectives;

***Finance, accounting, treasury and legal functions:*** The man- agement 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;

***Human resource management function:*** The HR function of each entity is co-ordinated by its management, which is

responsible for recruitment, development and training of the personnel including the pay structure.

Table B.2.2:

**Qualitative Relative Assessment of Functions Performed**

*(by A Co and B Co in relation to B Co’s Market)*

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

* + - * 1. **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 identify the significant assets (tangible as well as intangible) used by, or transferred between, the associated enterprises in the course of an international controlled transaction.
        2. 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 transac- tion. For economically significant assets it may be necessary to perform a more detailed analysis of the assets employed, such as their age, loca- tion, property right protections available, market value, etc.
        3. 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 applicable accounting standards, interest expenses are sometimes treated as operating expenses (“above the line”) or as financial expenses (“below the line”). Where interest expenses are

treated as operating expenses in the accounts of the taxpayer and/or of the comparable, they will be addressed in the comparability anal- ysis. Adjustment might be required to ensure consistency of account- ing 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.

* + - * 1. Where the transactions involve the use or transfer of economically significant intangibles, the special considerations set out in Chapter B.5 should be borne in mind.
        2. Continuing the above example, the following are the assets employed by the respective parties:

### Tangible assets owned by B Co

It is assumed for the purpose of the example that B Co owns the follow- ing tangible assets:

Land and buildings;

Plant and machinery;

R&D equipment;

Office equipment;

Furniture and fixtures;

Vehicles;

Computers; and

Testing equipment.

### Intangible asset ownership

It is assumed for the purpose of the example that:

B Co has established a research and development department which tries to increase the level of its performance by improv- ing 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 B Co’s business and to provide technical assistance to its customers. These efforts help to increase production efficiency and product quality;

B 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 A Co in Country A for which a technology agreement is in place with A Co;

B Co has entered into a technology license agreement with A Co for procuring technology for the manufacture of specified products. Thus B Co uses the process, know-how, operating/ quality standards etc. developed/owned by A Co. B Co lever- ages value from these intangibles for continued growth in rev- enues and profits;

A Co is the market leader in the development and supply of elec- tronic meters, as well as related software, energy monitoring, billing solutions and payment systems. Over the years the com- pany has amassed a wealth of proprietary technical knowledge. This includes product specifications, designs, the latest manu- facturing processes and empirical data on the usage of products by customers in the industry;

A Co enjoys a reputation for quality products. In the interna- tional utility markets, product supplies from international players from developed countries are preferred by the cus- tomers and utilities as compared to direct product supplies from suppliers located in developing countries. B Co lever- ages on A Co’s established brand name and reputation for high technology products. A Co’s commitment to quality also provides B Co with an edge while selling products in the domestic markets.

Table B.2.3:

**Summary of Assets Employed**

|  |  |  |
| --- | --- | --- |
| **Category** | **Level of Intensity** | |
|  | **A Co** | **B Co** |
| Tangible assets | ✓✓ | ✓✓✓ |
| Intangible assets | ✓✓✓ | ✓✓ |
| - Technological | ✓✓✓ |  |
| - Brand | ✓ | ✓ |
| - Legal | ✓ | ✓✓✓ |

### Risks Assumed

* + - * 1. Risk analysis is important in the functional analysis and it should be considered together with the functions and assets. The detailed guidance provided in this section on the analysis of risks as part of a functional analysis covering functions, assets, and risks, should not be interpreted as indicating that risks are more important than functions or assets. The relevance of functions, assets and risks in a specific trans- action will need to be determined through a detailed functional analysis.
        2. 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. As has been noted above, greater risks are associated with higher expected returns — profit-seeking enterprises would only take on risks associated with 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. Since the assumption of economically significant risks will be relevant to the pricing of a transaction, a transfer pricing anal- ysis must first identify such risks, and then determine which entity assumes them. This analysis will 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 rele- vant facts. Only then can the controlled transaction be properly under- stood and defined, and from there, appropriately priced. For transfer pricing purposes, the analysis of risk can be broken down into 6 steps, illustrated in the diagram below.

#### STEP 1: Identification of economically significant risks

* + - * 1. There are many sources and types of risk, the significance of which will vary depending on the nature of the business transac- tion. The significance of a risk will depend on a combination of its like- lihood 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
* Identify risks with specificity



1. Identifying risks

* Contractual allocation of risk



2. Contracts

* + How do the parties operate?
  + Control functions, risk mitigation

3. Functional analysis

4(i) Does conduct follow contract



YES

functions, up/down side consequences, financial capcity

NO



Test 4(ii) based on conduct

NO



4(ii) Control & financial capacity

5. Does another party have control & financial capacity

YES

One party

Multiple parties

No party

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6. Use this risk allocation to delineate the transaction& price it

Consider facts & circumstances; commercial rationality

Allocate to party with most control

Allocate to this party

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 developments based on novel technologies or wholly new applications are likely to be higher risk than those which build on existing, proven products or technologies.

* + - * 1. An examination of the key functions and commer- cial context of a transaction will help to identify significant risks. In many cases, an examination of the functions performed, assets used and risks assumed by other associated enterprises in the MNE group 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.
        2. 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 transaction.

Table B.2.4.:

**Illustrative List of Risks Assumed**

|  |  |
| --- | --- |
| **Nature of risks** | **Particulars** |
| 1. Financial risk | a. Method of funding |
|  | b. Fluctuation in interest rates |
|  | c. Funding of losses |
|  | d. Foreign exchange risk |
|  | |
| 2. 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 advertise- ment and product promotion, etc. |
|  | b. Fluctuation in demand and prices |
|  | c. Business cycle risk |
|  | d. Volume risk |

|  |  |
| --- | --- |
| **Table B .2 .4 . (cont’d)** | |
| **Nature of risks** | **Particulars** |
|  | e. Service incentive scheme risk |
|  | f. Asset redundancy risk |
|  | |
| 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 |

* + - * 1. 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 crea- tion of value depends on the industry and on the taxpayer-specific circumstances. Hence, real life knowledge of how a particular MNE is functioning *vis-à-vis* its associated enterprise is very crucial in deter- mination of the risk. For instance, not all industries involve the same level of product liability risk.

#### STEP 2: Contractual assumption of risk

* + - * 1. 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 contrac- tual 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. Most of the commonly assigned risks in the contract are risks which can be miti- gated 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 last decade has demonstrated that risks which are difficult to mitigate are often economically more significant than the kinds of contractual risks as mentioned above.

* + - * 1. Moreover, in some cases, written contracts may be incon- sistent or may not be followed in practice. For example, in a situation where a contract states that a manufacturer of electronic goods bears warranty risk, but in fact the reseller habitually pays for the cost of customer repairs made under warranty, it is the reseller that is bearing the risk in practice. The determination of the risk assumption between the parties must therefore have regard to the actual conduct of the parties, rather than merely to the legal form of the agreement.
        2. 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 paras B.2.3.2.32. to B.2.3.2.35. immediately below) and financial capac- ity (see paras B.2.3.2.36. to B.2.3.2.38. below) are necessary for the assumption of risk; but neither of them is by itself sufficient.

#### STEP 3: Functional analysis in relation to risk

* + - * 1. 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 impor- tant. This information will then be analyzed in the remaining steps.

#### Control over risk

* + - * 1. 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 enter- prises generally devote substantial resources to managing significant commercial opportunities and their inherent risks.

* + - * 1. 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 perfor- mance 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 miti- gation 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 con- tract 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 pro- duced, as well as timing of production. Company X is required to manu- facture 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, the latter will indemnify it against any warranty or compen- sation 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.

* + - * 1. 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 analyzes are provided by others, the decision-maker must be able to assess whether the right information has been provided, and whether the analyzes 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.
        2. The setting of the broad policy framework in which to assess risks is also not enough. For example, the setting by senior management of broad company objectives or a general company ‘image’ would not mean that such senior management control 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 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 opera- tions 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 man- power 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 it 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 deci- sions 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 suc- cess 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 group having operations worldwide through various sub- sidiaries. 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 per- sons 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 com- panies 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 man- agement 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 fur- nished 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 pro- gramme 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 sub- sidiaries for R&D activities.

STEPS 4-6 Analysis and conclusions: In this example all the core func- tions 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, utiliza- tion and control of the budget for carrying out R&D activities and deci- sions 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 a risk

* + - * 1. Where a risk has materialized it will be a question of fact as to which party bore the consequences. However, since any analy- sis 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 material- ize. 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.
        2. 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 materializ- ing (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 suffi- cient to assume a risk, a high level of capitalization does not necessarily mean that the highly capitalized party assumes the risk.

* + - * 1. It is relevant to mention here that in a multinational enter- prise associated entities may work together to exert control over the risks of the entire MNE group. Precise distribution of risk among the associ- ated enterprises may be extremely difficult to achieve. The transfer pric- ing analysis as to 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

* + - * 1. 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.
        2. 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 anal- ysis will be straightforward. That is, where a party, which is assigned a risk under a consistent contract (i.e. one that is followed in prac- tice) (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 determi- nation of the assumption of risk under the transfer pricing analysis. In some cases, risks may be contractually shared by more than one party.
        3. 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 allo- cation of risk is what should be used to define the transaction and price it for transfer pricing purposes (STEP 6). The other parties perform- ing control activities should be remunerated appropriately, taking into account the importance of the control activities performed.

* + - * 1. 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 enter- prises 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 paras B.2.3.1.4. to B.2.3.1.9. above).
        2. 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 exam- ple, the profits that result from a successful venture risk; but would also bear the potential downside consequences if the risk materializes result- ing 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 func- tions. 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 down- side 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. Continuing the example from Paragraph B.2.3.2.11., it is assumed for the purpose of the example that the following are the risks borne by the respective parties.

|  |  |  |
| --- | --- | --- |
| Table B.2.5:  **Risks Exposure** | | |
| **Risk Category** | **Exposure of A Co** | **Exposure of B Co** |
| **Product liabil- ity risk** | It is assumed that A Co faces this risk arising from the product failure, technology absorption by B Co and consequential reputational risk. Further, A Co is primarily engaged in product and technology development so this risk is also borne by A Co. | It is assumed that B Co faces product liability risk as a result of rejection where the products do not conform to the order speci- fication given by domestic power utilities. Risks aris- ing from non-conformity with customer specifica- tions or national/interna- tional product standards are borne by B Co. However, this risk is mitigated due to the excellent quality, safety standards and processes deployed by B Co and its own R&D centre. |
| **Technology risk** | It is assumed that A Co is exposed to higher  technology risk, being the technology owner. Due to market competition and an ever-changing technol- ogy scenario, the company needs to continuously upgrade its existing tech- nology and develop new technology. A Co continu- ously focuses on providing products with contempo-  rary technology. | It is assumed that the manufacturing operations of B Co are non-complex. Further, product technology and know-how have been provided by A Co. Hence, B Co does not face any major technology risk. |
| **Research and development risk** | It is assumed that since A Co serves diverse markets, its engineering and R&D professionals constantly strive to provide innova- tive solutions that offer competitive advantages for customers worldwide. | It is assumed that since no significant R&D (except for supporting B Co’s busi- ness and that of providing technical assistance to its  customers) is carried out by B Co, it faces no significant risk on this account. |

|  |  |  |
| --- | --- | --- |
| **Table B .2 .5: (cont’d)** | | |
| **Risk Category** | **Exposure of A Co** | **Exposure of B Co** |
| **Credit risk** | It is assumed that in the case of inter-company sales of technology and components A Co faces minimal risk. | It is assumed that all the major credit risks associ- ated with sales are borne by B Co. |
| **Inventory risk** | It is assumed that A Co is primarily engaged in product and technology  development and this risk is not borne by A Co. | It is assumed that B Co is responsible to manage the procurement of raw materials/components and maintain the requi- site stock levels for each  product including finished goods. However, this risk is mitigated to the extent that components are procured from A Co. |
| **Foreign cur- rency risk** | It is assumed that A Co exports technology and components to B Co; hence they are also sub- jected to appreciation/ depreciation of local cur- rency against the foreign currency. Hence A Co is also subjected to this risk. | It is assumed that since B Co imports technology and components from A Co and its sales are restricted to domestic markets, the imports are subjected to  appreciation/depreciation of local currency against the foreign currency. Hence B Co is subjected to this risk. |

|  |  |  |
| --- | --- | --- |
| Table B.2.6:  **Summary of Risks Borne by Each Party** | | |
| **Category** | **Level of Intensity** | |
|  | **A Co** | **B Co** |
| Market risk | \*\* | \*\* |
| Product liability risk | - | ®®® |
| Technology risk | ®®® | ® |
| Research and development risk | ®®® | ®® |
| Credit risk | - | ®®® |
| Inventory risk | - | ®®® |
| Foreign currency risk | ®® | ®® |

### Economic circumstances of the transaction

* + - * 1. Economic analysis deals with industry analysis and the circumstances that may be relevant for determining market compara- bility. The relevant information on the industry can be broadly classi- fied into following:

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.

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 signifi- cant profits in emerging economies. Where there are such significant differences between the economic circumstances prevailing in differ- ent markets such that it is not possible to eliminate them by making reliable comparability adjustments, then companies from such differ- ent markets might not be retained as reliable comparables.

* + - * 1. Undertaking a more detailed classification of the above broad headings would yield the following specific factors which may need to be looked at 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 posi- tions 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 driv- ers in the industry and the date and time of transactions;

The existence of a cycle (economic, business, or product cycle); and

Other relevant factors.

* + - * 1. Market prices for the transfer of the same or similar prop- erty may vary across different markets owing to cost differentials and/ or differences in purchasing power and habits prevalent in the respec- tive markets which may affect the market price. Markets can be differ- ent 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 analy- sis are discussed below.
        2. In general, uncontrolled comparables would first be sought from the **geographic market** in which the controlled taxpayer oper- ates, 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 mate- rial differences between the two markets.
        3. 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 possi- bility 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.

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.

* + - * 1. 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 coun- try. 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.

Cost savings (e.g. cheap labour)

-

Dis-savings (e.g. high

transportation cost)



=

Net location savings

* + - * 1. Location-specific advantages and location savings are defined as a type of benefit related to geographical location. The relo- cation 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 net- works, distribution system); or

Market premium.

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:

Net location savings

+/-

Other location- specific benefits

=

Location-specific advantages

* + - * 1. The incremental profit, if any, derived from the exploi- tation 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.

+/-

Other location- specific benefits



=

Location-specific advantages

=>

Location rent (i.e. incremental profit

* + - * 1. 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 poten- tial competitors also have access to the LSAs, much or all of the bene- fits of LSAs would be passed on to the customers through lower prices of products, resulting in little or no location rent. However, circum- stances 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 prod- ucts at a higher price. Alternatively, if an MNE has exclusive access to the LSAs, then the MNE may derive significant location rents associ- ated 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.

* + - * 1. 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 bargain- ing 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 possi- bilities. 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 asso- ciated 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 produc- ers 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.
        2. The next question would be the appropriate split consist- ent with the arm’s length principle. As discussed above, the bargain- ing 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 bench- marks are not available.
        3. 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 associ- ated enterprises are consistent with comparable uncontrolled transac- tions between independent enterprises.

* + - * 1. 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 privi- leges should be used as comparables, and if that is not possible, compa- rability 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 intangi- bles. However, such regulatory limits may not set arm’s length prices for services or intangibles. For example, assuming that all the trans- actions 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 author- ize 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.
        2. The market level of the company is another key factor; for example, the price at the wholesale and retail levels would gener- ally differ.
        3. Other market conditions — some other market conditions which may influence the transfer price 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.

### Business strategies

* + - * 1. On a general level business strategies are one of the impor- tant 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 depend- ent upon the structural characteristics of an industry. Nonetheless,

MNEs with different business strategies do exist within the same industry. In fact, the business strategy of MNEs may differ due to their different global integration — local responsiveness pressure, differ- ent corporate histories, internal efficiencies and competitive advan- tages. 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; impact of existing and planned labour laws, duration of arrangements and other factors bearing upon the daily conduct of business. Such business strat- egies may need to be taken into account when determining the compa- rability of controlled and uncontrolled transactions of the enterprises. However, the ultimate objective of a business strategy of an MNE is to improve its market share and/or overall profitability.

* + - * 1. 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.

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 competi- tive markets. Market maintenance occurs when an MNE has already entered a market and is aiming at maintaining its market share.

* + - * 1. 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.

* + - * 1. 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.

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 com- petitive in the market; and

Increasing their marketing and selling expenses through increased advertisement; sales promotion activities like offer- ing rebates, free samples, offering extended warranties etc. and increased marketing activities such as increasing the number of salespersons, commission agents or distributors and increased payments of commission to 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.

* + - * 1. Market penetration, market expansion and market main- tenance 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 defi- nite time frame in the foreseeable future when these strategies might yield profits. The allocation of the costs of these strategies between an MNE and its subsidiaries is an important issue in transfer pricing and will depend on the facts and circumstances of each case. It is impor- tant to examine the following factors in order to address this issue of cost allocation between parties to the 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 promo- tion 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 par- ties, i.e. their responsibilities and risk profile?

Does the strategy involve intangibles? and

Which party is the legal and economic owner of such intangibles?

For example, a limited risk company acting solely as a sales agent with little or no responsibility for market development would gener- ally not bear the costs of a market penetration strategy initiated by its parent company.

* + - * 1. 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 trade- marks, trade names etc. follow closely behind. Therefore, it is impor- tant 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”). It is recognized that market research; designing or planning products suitable to market needs, advertising, marketing and sales promotion strategies; after-sale services and networks of dealers and sales/commission agents may contribute to the creation of marketing intangibles depending on the facts and circumstances of each case.

## Selection of the Tested Party

* + - * 1. When applying the Cost Plus Method, Resale Price Method or Transactional Net Margin Method (see further Chapter B.3.) 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). 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 comparability is available. It may be the local or the foreign 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 compa- rables is furnished to the tax administration and vice versa in order for the latter to be able to verify the selection and application of the trans- fer pricing method.

## Identification of Potentially Comparable Transactions or Companies

* + - * 1. Comparable uncontrolled transactions (“comparables”) are of two types:

Internal comparables, i.e. transactions between one of the par- ties to the controlled transaction (taxpayer or foreign associated enterprise) and an independent party; or

**Third-party** or external comparables, i.e. comparable uncon- trolled transactions between two independent parties, neither of which is a party to the controlled transaction.

### Internal comparables

* + - * 1. Even though internal comparables may possibly display a higher degree of comparability there is a need to subject inter- nal 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.
        2. The advantages of internal comparables are:

Internal comparables may have a more direct and closer rela- tionship to the transaction under review than external ones due to one party to the transaction being the same and the use of identical accounting standards;

Transaction-specific financial and other information is more likely to be available;

Comparability analysis involving internal comparables may be less expensive for the taxpayer as no public database search is required.

* + - * 1. The potential disadvantage of internal comparables is that they may not necessarily be the best evidence if there are differences,

e.g. in transaction volumes, contractual terms, geographical markets and business strategy, which are material and cannot be eliminated through reliable comparability adjustments.

* + - * 1. Internal comparables, where available and reliable, may allow the taxpayer to consider the use of the Comparable Uncontrolled Price Method because it is the most direct method. Internal comparables may also be used with the other recognized transfer pricing methods.
        2. However, reliable, internal comparables may not exist to cover the scope of the controlled transactions under consideration. Thus, the taxpayer often needs to examine external sources of poten- tial comparable transactions among third parties.

### Third-party comparable/external comparable

* + - * 1. There are two types of third party or external comparable. 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 uncon- trolled parties.
        2. The second type of third party or uncontrolled compa- rable relates to comparable uncontrolled companies, for example in the application of profit-based methods. The identification and selec- tion of these reliable external comparables can be executed in a five step process:

1. Examination of the five comparability factors for the con- trolled transaction;
2. Development of comparable search or “screening” criteria;
3. Approach to identifying potential comparables;
4. Initial identification and screening of comparables; and
5. Secondary screening, verification and selection of comparable.
   * + - 1. An illustration of how such a process can be performed follows; it is applicable especially in cases where external comparables are extracted from a database.

### Examination of the five comparability factors

* + - * 1. Examination of the five comparability factors for the controlled transaction will help both in understanding the taxpayer’s

controlled transaction to select the most appropriate transfer pricing method and in developing search criteria to identify comparables in order to apply the selected method.

### Development of comparable search or “screening” criteria

* + - * 1. Comparable search or “screening” criteria are devel- oped based upon the results of the above-mentioned examination of the five comparability factors in relation to the controlled trans- action. These criteria must be defined so as to identify those exter- nal 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 poten- tial comparables have been selected comparability adjustments can be performed where necessary to enhance the reliability of the compar- isons. Availability of reliable comparables will influence the choice of the most appropriate transfer pricing method.
        2. 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 deter- mine whether they qualify as comparables. The database screening is generally applied with regard to industry code, geographic location, level of market, business mix, scale of operations, independence and financials. The quantitative screening often involves screening the financial information relating to the potential comparables for the relevant period to determine whether they have comparable finan- cial information or report sufficient operating profit data. However, qualitative screening is mostly used by applying various financial ratios (referred to as diagnostic ratios) to the remaining potential set of comparables. The qualitative screening is generally performed by diagnostic ratio to reject or accept comparables based on the quali- tative information available. After the qualitative screening has been performed the final set of comparables remains. The selection criteria must be tailored to the characteristics of the controlled transaction

under examination. The criteria below must be matched with the spe- cific transfer pricing method chosen:

Figure B.2.1:

### A Typical Screening Process

Final Set of Comparables

Qualitative Screening Comparability Reviewed (Tertiary Screening)

Quantitative Screening Comparability Reviewed (Secondary Screening)

Database Screening Comparability Reviewed (Primary Screening)

Identifying Potential Comparables

* + - * 1. With regard to geographic location and the product/service market, independent companies operating in the same market(s) as the tested party, where available, will generally be preferred. However, in many countries, especially developing countries, the availability of independent comparables, or of public information on independent comparables, is limited. Use of foreign comparables may therefore be needed, although this can also be difficult for many developing coun- tries without access to relevant databases and with limited resources to analyze and adjust the foreign comparables.
        2. To select the mix of functions and the level of market, comparables will generally be selected among companies performing the same or a similar mix of functions as the tested party and operat- ing at the same level of market.
        3. In considering the appropriate business mix, compa- nies engaged in significant business activities that are substantially

dissimilar to the controlled transaction and are not adequately disclosed to allow segmentation should be excluded from the set of comparables.

* + - * 1. Comparables must be selected so that their finan- cial performance reasonably reflects the scale of economies of the controlled party, depending upon the nature of the business. Size criteria in terms of sales, assets or number of employees are often used, as the size of the transaction in absolute value or in proportion to the activities of the parties might affect the relative competitive positions of the buyer and seller and therefore affect comparability.
        2. Only uncontrolled transactions can be used as compara- bles. However, companies having small associated party transactions which do not materially affect their gross or net margin may still be used as uncontrolled comparables.
        3. Public or private companies reporting in a reasonably standard format with a detailed income statement and balance sheet data provide an objective baseline for subsequent analysis. Restricting the comparable search to public companies also has clear advantages. Many regulatory agencies around the world require filing of audited financial statements that conform to generally accepted accounting principles (GAAP). Also public companies provide considerably more detail in their audited financial statements and in the accompanying notes and management review of operations. Further, audited finan- cial statements are available in a relatively consistent form over time, including retrospective restatement of data wherever necessary, which allows for the use of a multi-year statistical analysis that can be applied in prospective pricing decisions.
        4. External comparables must be selected such that the rele- vant operations and available financial data appropriately reflect the business cycle and general economic circumstances of the year or period at issue. Contemporaneous transactions are most likely to reflect similar economic conditions and ensure a higher degree of comparability. However, there can be exceptions to the above general rule and multiple year data may also be considered if such data reveals facts which could have an influence on the determination of transfer pricing in relation to the transactions being compared.
        5. Examining multiple year data may be useful in a compa- rability 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 prod- uct or intangible. However, the existence of any such cycle needs to be aptly demonstrated by the taxpayer.
        6. The search for comparables may be aided by a quantitative screening tool using diagnostic ratios. Diagnostic ratios are financial ratios applied to reject comparables that do not fulfil certain criteria. If used, quantitative screening should be applied to improve the relia- bility of the set of comparables.
        7. The application of diagnostic ratios is based on the assump- tion 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. 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. Diagnostic ratios enable some of the features of a potential comparable that are econom- ically relevant for the comparable search process to be taken into account when performing the comparable search.
        8. 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 oper- ating 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 like 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.
        9. 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.

### Approach to identifying potential comparables

* + - * 1. In identifying potentially comparable uncontrolled trans- actions or enterprises two approaches are possible: the “additive” and the “deductive”.
        2. 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. The taxpayer then collects as much information as possible on these trans- actions to confirm whether they are in effect acceptable comparables, based on the five comparability factors 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. 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 a wide set of companies that operate in the same sector of activity, perform similar broad functions, and do not present economic characteristics that are obviously different.
        4. 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.
        5. It is possible that companies identified using the addi- tive approach may not have been identified when using the deduc- tive approach. This may in some cases suggest that the search strategy

applied under the deductive approach is not sufficiently robust and should be reassessed. Therefore, the additive approach could be useful for assessing whether the deductive search strategy is reliable, compre- hensive and appropriate given the economic characteristics being considered.

* + - * 1. It is very important that the taxpayer or tax administra- tion 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

* + - * 1. The next step, after having developed a set of comparabil- ity criteria that are tailored to the specifics of the controlled transaction at issue, is to conduct an initial identification and screening of poten- tial independent comparables. The objective in this initial screening, where performed using a commercial database, is to identify substan- tially 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, verifica- tion, and analysis. Where comparables are selected from information sources other than databases this part of the process may be different.
        2. 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. 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 dil- igence; and

It should be recognized that some of the initial comparables will be eliminated in subsequent stages of screening and analysis.

### Secondary screening, verification and selection

* + - * 1. 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 selec- tion. This process is based on trial and error and requires multiple data sources, cross-checks and selected follow-up and confirmation of factual data.
        2. The person performing the search for comparables may have to use a variety of information sources for third party or exter- nal 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 intermedi- ate screening has been completed a complete set of company finan- cial 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. There are various sources of data and information which are available to assist a taxpayer or tax administration in identifying potential comparables. Possible sources range from electronic data- bases to regulatory and other government filings and various analyt- ical 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.

* + - * 1. 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 infor- mation about potential comparables. Each source can be important in establishing and documenting the quantitative basis for an arm’s length transfer pricing policy.
        2. A key resource among the general sources of information is that of electronic databases. These databases have been developed by various organizations which compile accounts filed by companies with the relevant administrative bodies and present them in an elec- tronic 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 infor- mation such as short business descriptions, although the level of detail largely depends on the country concerned.
        3. The advantage of electronic databases in the comparable search process 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.
        4. Criteria commonly used for initial screening may include the following list. The relevance of the screening criteria below depends on the facts and circumstances of each particular case and the list here is purely indicative:

Geographic restrictions with respect to a country or region;

A specific industry classification;

Certain keywords;

Elimination of those enterprises which may have substantial transfer pricing issues themselves and fail an independence screening;

Inclusion or exclusion of specific functions such as research and development, production, distribution or holding of shares;

Exclusion of companies which were only recently set up;

Consideration of diagnostic ratios such as turnover per employee, ratio of net value of intangibles/total net assets value or ratio of research and development/sales etc.; and

A focus on sales volume, fixed assets or numbers of employees.

* + - * 1. It is important to note that electronic databases rely on publicly available information. These databases may not be availa- ble 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 transactional information is generally not readily available.
        2. 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 commer- cial 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 iden- tify 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.

**Example: Information Technology Company**

X Co is a subsidiary of software company Y Co based in Y Country which is in the business of information technology to create innovative software solutions for financial, pharmaceutical and technology companies.

X Co is a captive service provider related to software development and maintenance solutions for the parent company. From this discussion it is clear that X Co has only one type of international transaction with

the related party, namely, the provision of offshore software develop- ment services.

|  |  |  |
| --- | --- | --- |
| **Box Table 1: Functions performed** | | |
| **Description of functions** | **X Co** | **Y Co (AE)** |
| Product R&D, design and concept | - | ®®® |
| Testing of the product | ® | ®®® |
| Marketing function | - | ®®® |
| Service function | ®® | ® |
| After-sale function | - | ®®® |
| Accounts function | ®®® | - |

**Box Table 2: Assets employed relating to X Co’s operation**

|  |  |  |  |
| --- | --- | --- | --- |
| **Description of assets** | **X Co** | **Y Co (AE)** | **Comments** |
| Skilled workforce | ®®® | - |  |
| Property, plant and equipment | ®®® | ® |  |
| Intangibles | - | ®®® | Any technical knowledge acquired during the project is retained in the Country of X Co. The Y Co trade- mark is not registered in the Country of X Co. |

**Box Table 3: Risks assumed**

|  |  |  |  |
| --- | --- | --- | --- |
| **Description of risks** | **X Co** | **Y Co (AE)** | **Comments** |
| Credit risk of customers | - | ®®® | Y Co (AE) raises invoices on the end clients. Hence, AE assumes the risk of col- lecting receivables from the clients. |
| Service level quality risk | ®®® | - |  |
| Working capital risk | - | ®®® | X Co is compensated by the AE in advance and hence, is not required to seek finance to fund its working capital. |

|  |  |  |  |
| --- | --- | --- | --- |
| Foreign currency risk | ®®® | - |  |
| Material risk | - | ®®® |  |
| Software technology risk | - | ®®® |  |
| Human capital risk | ®®® | - |  |

Since the controlled transactions of X Co are being tested, it is taken as the tested party. Further, it is assumed that searches for potentially com- parable companies were conducted on publicly available data sources.

The steps in the selection process can be summarized as follows (table provided for illustration purposes):

**Box Table 4: Steps in selection process**

|  |  |  |
| --- | --- | --- |
| **Criteria** | **Number of com- panies passing the criterion** | **Explanation** |
| Company’s main economic activity | 764 | Company primarily engaged in providing computer soft- ware, software services and  consultancy |
| Financial data as of March 2007  onwards | 411 | Companies where the latest data is not available have been  excluded |
| Sales > US$ 10  Million | 280 | To eliminate companies whose  sales are less than US$10 Million |
| Wages to sales ratio**a** | 157 | To eliminate companies whose wages to sales ratio is less than or  equal to 25% |
| Qualitative analysis | 8 | Companies which fall under the categories of “different line of business activity”, “related party transactions”, “loss making” (an average loss over a 3 year period)b  or “data unavailable for review” were not considered. |

***a*** This criterion is used here due to the fact that the company under review engages in the provision of services, which assumes the need for a

significant work force. Wages are therefore a major factor in the revenue earned, and thus these criteria can be used in specific situations in the process of elimination.

***b*** This is for the purpose of this example and does not mean that loss-

making comparables should always be excluded. See Paras B.2.4.4.2. and

B.2.4.5. for discussion of losses.

* + - * 1. There are other sources of comparable data available. These provide a more detailed business mix, product line, geographic market, functional mix and ownership information on the first-round selection of potential comparables. They also help identify additional companies that should be considered. These sources 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:

h Chambers of commerce;

h Trade and professional organizations;

h Embassies, consulates or trade missions; or

h International organizations (e.g. the United Nations, the Organisation for Economic Co-operation and Development, the World Bank, the International Monetary Fund).

* + - * 1. The following example addresses the practical application of screening.

## Adjustments to Comparables

* + - * 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 may be considered before an adjustment is made:

Quality of data being adjusted: the comparability adjustment may only be applied where it can improve the reliability of

comparables. If the search process for comparables has major shortcomings, adjustments may not be applied to poor compa- rables which would require too many adjustments;

Purpose of adjustment performed: differences that have no material effect on comparability should not be adjusted;

Not every transaction being compared is capable of being adjusted: there are transactions that may be adjusted but some other transactions like those concerning goodwill or intangi- bles may not be capable adjustment;

Reliability and accuracy of the adjustment: the adjustment should be calculated based on objective and verifiable data; and

Documentation: comparability adjustments are part of the com- parability analysis and should be appropriately documented in order to ensure its reliability.

* + - * 1. Comparability adjustments can be divided into the follow- ing three broad categories:

1. Accounting adjustments;
2. Balance sheet/working capital adjustment; and
3. Other adjustments.
   * + - 1. Accounting adjustments. There are various types of differ- ence in accounting standards and practices between the tested party and third parties used as comparables which may lead to measure- ment errors if adjustments are not made. The accounting differences can be grouped under the following categories of classification differ- ences and differences under relevant law or standards.
         2. 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 (Resale Price Method);

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 (Cost Plus Method); 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 Transactional Net Margin Method (TNMM). However, even when using TNMM on a net margins 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 compa- rables, for example different depreciation periods, treatment of employee’s stock options etc.

* + - * 1. Other accounting differences under relevant law or stand- ards 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 signif- icant 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 com- panies; and

Different accounting standards followed in different countries.

* + - * 1. 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 differ- ing 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 signifi- cantly different level of asset intensity may require further investiga- tion of the comparability characteristics of the potential comparable and merely making a working capital adjustment would not alleviate the problem.
        2. 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 reason- ably made and they improve comparability.
        3. 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 compara- ble is recomputed.
        4. The following example shows how the results of the compa- rable are adjusted to reflect the tested party’s levels of working capi- tal. 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 compara- ble’s results to reflect “zero” working capital. In general, working capi- tal 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 capi- tal (WC) adjustment so computed is either adjusted to the comparable’s PLI or to the Tested Party’s PLI for the purpose of comparison.



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**Example: Information Technology Company (continued)**

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

**Box Table 5: Working capital adjustment**

Comparable Party PLI

Tested Party PLI

Interest

Working Capital (WC)

Tested Party WC

Comparable Party WC

|  |  |  |
| --- | --- | --- |
| **Particulars** | **Tested Party** | **Comparable Party** |
| Sales (A) | 100 | 120 |
| Earnings before interest and taxes (EBIT) (B) | 5 | 7 |
| Operating profit margin (PLI) (A/B in %) (C) | 5% | 5.8% |
| Net working capital (NWC) |  |  |
| 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 | 70% | 83.3% |
| Difference between net working capital to sales of tested and compa- rable party (H) |  | -13.3% |
| Interest rate on NWC (I) |  | 5% |
| Adjustment (J) (I\*H) |  | -0.7% |
| Working capital adjustment – |  |  |
| Re-computing the PLI for the comparable (C-J) |  | 5.1% |

* + - * 1. 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 differ- ences in the mix of functions performed by the potential comparables vis-à-vis the tested party, or in the assets used, risks assumed or capi- tal employed. When such differences exist and are not adjusted, they may affect the reliability of the comparables in establishing an appro- priate arm’s length profit range.
        2. The **financial results of the comparables** may need to be adjusted to eliminate the effect of such differences. Such adjust- ment 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 addi- tional 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. There can be significant differences in the mix of func- tions 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 deter- mined 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.
        4. Adjustments performed to adjust for material differ- ences 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 opera- tions and downstream distribution functions that are not performed

by the controlled storage device distributor. In this case, the finan- cial 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 down- stream distribution transactions. In other words, for comparabil- ity purposes, only the functions comparable to the functions carried out by the controlled storage device distributor should be taken into consideration.

* + - * 1. To contrast the treatment above with a different set of circumstances, it is assumed that the controlled storage device distribu- tor above performs some import functions which are not performed by the independent distributors. The margins of those comparables that did not perform import functions would, in these circumstances, need to be adjusted to reflect an arm’s length profit associated with these functions.
        2. 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 comparabil- ity adjustments. In such cases, the potential comparable may need to be rejected.
        3. 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 prin- ciple. However, the actual return may or may not increase depending on the degree to which the risk is actually realized. As such, similarity in the level of risk is an important consideration in selecting comparables.
        4. 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 adjust- ment. For example, a contract manufacturer in certain circumstances does not usually assume the market risk that full-fledged manufactur- ers customarily do.

B.2.73.5.18. There is no universally accepted method for risk adjust- ment. 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 prof- itability 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.

* + - * 1. It has to be recognized that problems can arise due to significant differences in the **transactional structure** between asso- ciated party sales in a controlled company and similar transactions involving independent companies.
        2. 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 independ- ent 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 independ- ent companies are undertaken between the associated enterprises.
        3. 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 enter- prises in an MNE group. 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 exam- ple, 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.
        4. 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 materi- ality 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.
        5. Comparability adjustments are only appropriate for differ- ences that have a material effect on the comparison. A comparison may be appropriate despite an unadjusted difference, provided that the differ- ence does not have a material effect on the reliability of the comparison.
        6. No specific rules or guidelines can be given that may be applicable to every transaction or indicate that comparability adjust- ments must be made. In each case, the critical factors that have a mate- rial impact on the price of the product (if the Comparable Uncontrolled Price Method is used) or on profit (if the Resale Plus Method, Cost Plus Method, Transactional Net Margin Method or Profit Split Method is used) should be identified. Ultimately, this decision depends 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.
        7. 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 informa- tion. That realization can be helpful in deciding whether a particu- lar difference is material enough to make adjustments, or whether the comparability difficulties should affect the selection of the most appropriate method.

## Comparability Considerations in the Selection of Transfer Pricing Methods

* + - * 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 (espe- cially 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. For further information see Chapter B.3.
        2. Once the taxpayer has identified the transfer pricing meth- ods that are potentially applicable to the controlled transaction, appli- cation of the most appropriate method rule involves a careful balance in which the following factors may be taken into account to assess the relative accuracy of the identified methods:

The extent to which the comparability factors (characteristics of the property or services, functional analysis, contractual terms, economic circumstances and business strategies) of uncon- trolled transactions or entities are similar to the controlled transactions or entities, given the type of comparability that is required under each pricing method;

The availability and reliability of financial and other informa- tion that is known about the comparable;

Reliability and accuracy of the comparability adjustments; and

Reliability of presumptions as well as deficiencies in data and presumptions.

## Determination of an Arm’s Length Price or Profit (or Range of Prices or Profits)

* + - * 1. Once the transfer pricing method is selected, the next logi- cal step is to apply the selected method to arrive at the correct arm’s length price or profit (or range of prices or profits), which is dealt with more fully in Part B.3. on Methods.

## Documentation of the Comparability Analysis and Monitoring

* + - * 1. Another important and necessary requirement while performing the comparability analysis is to maintain complete docu- mentation of the analysis, evaluation and selection (as well as rejec- tion) of comparables along with a substantiation of the adjustments, if any, made. Complying with documentation requirements may be a significant but unavoidable burden for the taxpayer. ChapterC.2. deals in detail with documentation requirements.

## B .2 .4 Issues Regarding Comparability Analysis

* + - 1. **General**
         1. The comparability analysis should be as reliable as possi- ble and on many occasions does not tend to 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. The key concerns surrounding comparability analysis are described below.

## Timing Issues

* + - * 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.
        2. **Timing of origin** of the transactions needs to be consid- ered. In principle, information relating to the conditions of compara- ble 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 infor- mation to use in a comparability analysis, because it reflects how inde- pendent parties have behaved in an economic environment that is the same as the economic environment of the taxpayer’s controlled transaction.
        3. **Timing of collection** of the relevant comparable data is also a key 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 intra-group 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 circum- stances 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.
        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.

* + - * 1. 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 trans- fer pricing rules. Country views differ as to whether data on contempo- raneous 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.
        2. Another key question is whether, and if so 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 valua- tion uncertainty in the pricing of the transaction.
        3. 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 valua- tion 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 enter- prises would have done or agreed between them.

* + - * 1. **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 signif- icance of facts and events with the benefit of knowledge accruing after they have occurred.

## Lack of Reliable Comparables

* + - * 1. One of the most frequent problems taxpayers and admin- istrations face with comparability analysis is the lack of reliable compa- rables with respect to the transaction(s).
        2. The lack of comparables for a taxpayer’s controlled transac- tion is not determinative in that it does not mean that such transaction is or is not at arm’s length or that the arm’s length principle is not appli- cable to that transaction. In some instances where no comparables are found for a controlled transaction between associated enterprises, it may become necessary to determine whether the conditions of the transac- tion are such that they might be expected to have been agreed between independent parties in similar circumstances — lacking evidence of what independent parties have actually done in similar circumstances.

### Absence of data

* + - * 1. In many developing countries, reliable comparable trans- actions simply may not be available. This may be due to the fact that a particular sector was only recently liberalized by the government or due to the advent of a new sector or industry in the region. The available comparable transactions in such cases are at best inexact and have to be adjusted to arrive at a reasonable degree of comparability. It may be possible under certain circumstances to use foreign compara- bles, possibly adjusted, to deal with these situations, but even then the administration may not have access to relevant databases and is there- fore very reliant on the taxpayer’s use of the data.
        2. Another possibility might be to use local comparables from another industry sector which provide sufficient and reliable

functional comparability. For instance, if the tested party is a manu- facturer in a new industry for which independent comparables are not found, it may be possible to use as comparables manufacturers that have a comparable functional analysis but operate in another industry.

* + - * 1. Comparable data may not be available in the public domain in many developing countries, or there may not be enough resources or processes in place to collate and make available such data for public consumption. It may be possible under certain circumstances to use foreign comparables, possibly adjusted, to deal with these situations.

### Use of new technologies, products and services, impact of business consolidation

* + - * 1. When products, property or services are offered by first-movers in specific segments there may be a dearth of comparables. These transactions typically involve 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.
        2. Owing to consolidation and vertical integration, it may be extremely difficult in some industries to find reliable internal or exter- nal 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 trans- actions 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.

## “Cherry-picking” of Comparables

* + - * 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 infor- mation by either the taxpayers or the tax authorities, ignoring other information that does not support the position argued for.

* + - * 1. For example, extreme results may be rejected as compa- rables after careful consideration by the tax authorities as they tend to skew the data. While this could on the one hand be a correct appli- cation of the arm’s length principle in certain circumstances, on the other hand the reasons for a loss may be genuine and may not always justify rejecting the loss-making company from the pool of compara- bles. This may be for example where the loss is due to a recession year which hit the controlled and uncontrolled transactions in the same way, or where it is due to the independent enterprise being in a start-up phase while the associated enterprise is also in a comparable start-up phase, etc.
        2. To come to a correct conclusion, an unbiased analysis of the facts and circumstances surrounding the transactions has to be carried out. Where one or more of the potential comparables are loss-making, further examination would be needed to understand the reasons for such losses and confirm whether the loss-making transac- tion or company is a reliable comparable. The losses might be due to exceptional conditions met by an otherwise comparable third party. Simple or low-risk functions in particular are not expected to gener- ate losses for a long period of time. This does not mean, however, that loss-making transactions can never be comparable. In short, it is the facts and circumstances surrounding the company in question that should determine its status as a comparable, not its financial result.
        3. Well-documented search procedures and comparabil- ity criteria make 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.

## Losses

* + - * 1. Analysis of the losses of an enterprise in an MNE group is an important process both in selection of comparables and in making

comparability adjustments to the tested party or comparables. This requires careful scrutiny focusing on the type and nature of the losses, period of loss-making and the reasons for such losses. In an MNE group one of the enterprises may be suffering a loss, even a recur- ring one, but the overall group may be extremely profitable. An enter- prise that is doing business with profitable members of its MNE group while generating losses itself may warrant scrutiny by the tax author- ities concerned. Such a situation may indicate that the loss-making enterprise is not getting adequate compensation from the MNE group in respect of its activities.

* + - * 1. The tax authorities must appreciate the fact that the losses discussed in the above paragraph, if short-term, may be the result of a deliberate business strategy for market penetration. Nevertheless, in such cases the question of who will bear the cost of market penetration should be carefully examined. For example, the allocation of market penetration expenditure to a limited risk bearing entity is questionable. The expenditure may be more correctly allocated to another company in the MNE group, as limited risk entities typically do not engage in such entrepreneurial activity.
        2. There could be a number of causes for losses. The most common include:

The level of the operation;

The spread of losses with the MNE group, i.e. losses may occur only within a single entity in the MNE group or at the overall level of the MNE group;

Losses could be specific to a single product line or to multiple product lines, or relate to all the products;

Loss making history within the entity and within the MNE group; or

Losses on account of natural disasters.

* + - * 1. The losses discussed in the previous paragraph can occur for a number of reasons including start-up losses, poor management, deliberate business strategies, excessive financial risk, the business cycle stage or adverse economic circumstances. There are also situa- tions in which specific products result in overall losses for the MNE, but the MNE is itself profitable because it sells other product lines at a

profit. Losses in particular product lines arise for a variety of reasons, including increased competition, product lines at the beginning or end of their life-cycle or quality issues.

* + - * 1. Start-up losses: Depending on the place of business and the line of trade or industry, a new business entity may be unprofita- ble during the start-up period. The allocation of a quantum of start-up costs and the period of such losses within the MNE group will depend upon the risk of each entity of the MNE group. In general, a limited risk entity would not be willing to absorb start-up costs as compared to a risk bearing entity. On the other hand, the allocation of start-up losses to an enterprise operating in a new location as a full-fledged operator with considerable entrepreneurial risk may not be questiona- ble in the initial years as it may be reasonable.
        2. Deliberate business strategies: An MNE might under- take deliberate business strategies for market penetration to increase market share and profit potential, resulting in losses in some juris- dictions. However, such business strategies may only justify losses for a limited period. Generally, associated parties are expected to act in the same way as independent companies under comparable circum- stances and therefore such strategies are acceptable if the business and the economic circumstances require them. However, the allocation of costs of market penetration will depend upon the risk profile of the entities in an MNE group. In uncontrolled circumstances the limited risk bearing entity is not likely to absorb the costs of a market penetra- tion strategy.

### Losses caused by recession

* + - * 1. Whether an entity should share or absorb the losses of a recession will depend upon the facts of each case. Three important issues arising from a recession need to be examined to determine the appropriate allocation of such losses.
        2. The impact of a recession may vary from country to country; for example in the year 2009, the recession was experienced more in developed countries as compared to emerging economies. Accordingly, the location of the associated enterprise is an impor- tant factor in deciding the question of sharing the losses of an MNE group. Profitability may also vary across industries. While a particular

industry may experience significant losses other industries may not be hit by the recession. This may be a relevant factor if the best available comparables are in a different market or industry.

* + - * 1. The sharing or absorption of the losses due to a reces- sion will depend upon the risk profile of an entity. Sharing of such losses by risk-free or limited risk bearing entities would generally be unreasonable.
        2. Support payments and associated loss transfers will require close scrutiny of the inter-company agreement. It is possible that an MNE may sell to customers at a loss due to a sharp decline in customer demand in a recessionary market, in order to protect its market share. At arm’s length, the sharing of such losses between the associated enterprises will depend upon the contractual risk profile of each. It is reasonable to assume that a limited risk or risk free distrib- utor would not share in such losses at arm’s length.
        3. Losses may arise from increased competition. Sometimes a product faces competition because the competitors attempt to gain market share by reducing prices or by increasing their marketing expenses, thus creating a loss for the MNE. A transfer pricing analy- sis should determine which legal entity should bear the cost of “market competition”. Depending upon the comparability analysis, includ- ing the functional analysis, a possible solution may be that this cost is borne by a full-fledged manufacturer with considerable entrepre- neurial risk.
        4. Losses may occur due to product life-cycle issues. The life cycle has four phases: start-up, growth, maturity and decline. Products at either the beginning or end of their product life cycle may make losses. At the beginning of the life cycle, volumes may be too low to allow efficient manufacturing (realization of economies of scale) which may result in the manufacturer incurring losses. At the other end of the life cycle one of the choices for the MNE is to retain the products to offer a complete product line to customers even though the prod- ucts may have been replaced by newer technology. However, in this case attributing the overall loss to the risk bearing entity may require further scrutiny. Any losses in the growth and maturity stage may involve intensive scrutiny by the tax administration because losses in these phases are most unlikely.
        5. Losses arising from quality issues are another key concern. Poor quality ordinarily arises from design-related activities, R&D or from manufacturing issues. In the latter case, depending upon the facts and circumstances, including the risk profile of the entities in question, the arm’s length position can be that the manufacturing affiliate is expected to bear the losses arising from its manufactur- ing activities. The party responsible for the design or R&D, depending upon the facts and circumstances including the risk profile of the enti- ties in question, may need to bear the losses arising from that faulty design or R&D.

## Intentional Set-offs

* + - * 1. A deliberate or intentional set-off occurs when an associ- ated 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.
        2. Set-offs can be quite complex; they might involve a series of transactions and not just a single transaction or at least two parties to set-off. Ideally the parties 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. The tax authorities may evaluate the transactions sepa- rately 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 domes- tic 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.

## Use of Customs Valuations

* + - * 1. The price paid or payable for the goods (and under certain circumstances services — the so-called “adjustments”) in import

transactions is the starting point for determination of the assessment of customs duties. A higher price on import reduces the profit and thus the direct tax, while a low price on import lowers the customs duty. Accordingly, there may be perhaps an inherent conflict between the revenue implications and the motivation of the customs and direct tax authorities. While the direct tax authority may seek to lower the price on import to stop diversion of profit, the Customs authority will seek to ensure that the declared Customs value has not been underval- ued to reduce duty liability.

* + - * 1. The WTO Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 (‘the Agreement’) sets out the methodology for determining the Customs value of imported goods. Customs valuation is the procedure applied to deter- mine the customs value of imported goods for the purpose of calculat- ing ad valorem customs duties. Members of the WTO are required to give effect to the Agreement in national legislation.**37** The tax author- ities in most of the member countries use the “arm’s length princi- ple” as a standard as set out in OECD Transfer Pricing Guidelines. It is important to note here that both the methodologies set by the WTO and OECD aim at determining a price for related party transac- tions, as if the parties were not related; the approaches of the Customs authorities and direct tax authorities are, however, often different and incompatible due to different motivations, theoretical frame- works, documentation requirements and other factors. There is a need to achieve a convergence of transfer pricing and customs valuation through better coordination and exchange of information between these two authorities.
        2. 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 authori- ties may have transfer pricing documentation which provides detailed information on the circumstances of the transaction. Some Customs administrations are now making use of transfer pricing data, as

37 See <http://www.wto.org/english/tratop_e/cusval_e/cusval_e.htm>

appropriate, to ensure that the price of an associated party transaction has not been affected by the special relationship between the parties. Customs authorities may use comparisons between the value attrib- utable to goods imported by associated enterprises and the value for identical or similar goods imported by independent enterprises, where available, or alternatively may examine the circumstances surround- ing the sale. There are some similarities between customs valuation and transfer pricing methods, although the former may not be aligned with the latter. Examining customs values may provide relevant infor- mation and a useful starting point for transfer pricing purposes and may also help in reducing the compliance burden for taxpayers.

* + - * 1. Even when utilizing import customs values in a trans- fer pricing context, certain additional upward or downward adjust- ments may be required to derive the arm’s length price for the purpose of direct taxation. Such adjustments may have an impact on the customs value.
        2. There is 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 Technical Committee on Customs Valuation, which has the mandate for ensuring, at the technical level, uniformity in interpretation and application of the Agreement, has issued two instruments on this topic: Commentary 23.1, which recog- nizes the principle that a transfer pricing study may be used by Customs as a basis for examining the circumstances of the sale, on a case by case basis; and Case Study 14.1, which sets out a scenario where Customs use transfer pricing data, based on the transactional net margin method, to confirm that a related party transaction has not been influenced by the relationship between the parties.**38**

38 Available in the WCO Valuation Compendium, via the WCO Book- shop: [http://wcoomdpublications.org/valuation/compendium-customs-valu](http://wcoomdpublications.org/valuation/compendium-customs-valuation.html) [ation.html](http://wcoomdpublications.org/valuation/compendium-customs-valuation.html)

* + - * 1. The WCO has produced a Guide to Customs Valuation and Transfer Pricing**39** 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 busi- nesses. In particular, Customs and tax administrations are encouraged to work more closely together and the guide emphasizes that businesses should consider Customs’ needs when developing transfer pricing strat- egies. 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.**40** These Guidelines endeavour to provide guidance and ideas to Customs and Tax authorities for formal- izing the contacts and strengthening the existing cooperation at the national level, on a range of issues of mutual interest.

## Use of Secret Comparables

* + - * 1. Concern is often expressed by taxpayers, especially MNEs, over aspects of data collection by tax authorities and its confidential- ity. Tax authorities have access to, as they need to, very sensitive and highly confidential information about taxpayers, such as data relat- ing 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.
        2. A secret comparable generally refers to the use of informa- tion 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 exam- ple, reveal confidential information about a competitor (i.e. the first taxpayer — to which the data relates).
        3. There is a need to exercise caution against the use of secret comparables unless the tax administration is able, within the limits of

39 Available from [http://www.wcoomd.org/~/media/wco/public/global/](http://www.wcoomd.org/~/media/wco/public/global/pdf/topics/key-issues/revenue-package/15-_-wco-guide-to-customs-valuation-and-transfer-pricing-_-final_en.pdf?db=web) [pdf/topics/key-issues/revenue-package/15-\_-wco-guide-to-customs-](http://www.wcoomd.org/~/media/wco/public/global/pdf/topics/key-issues/revenue-package/15-_-wco-guide-to-customs-valuation-and-transfer-pricing-_-final_en.pdf?db=web) [valuation-and-transfer-pricing-\_-final\_en.pdf?db=web](http://www.wcoomd.org/~/media/wco/public/global/pdf/topics/key-issues/revenue-package/15-_-wco-guide-to-customs-valuation-and-transfer-pricing-_-final_en.pdf?db=web)

40 Available to download from [http://www.wcoomd.org/~/media/wco/pub](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) [lic/global/pdf/topics/facilitation/instruments-and-tools/tools/customs-tax-](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) [coop eration/customs\_tax\_guidelines\_en\_final2.pdf?db=web](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)

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 trans- actions with comparables not available to it, without the opportu- nity 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, typi- cally coupled with interest, penalties etc. Furthermore, double taxa- tion may not be relieved if secret comparables cannot be disclosed to the Competent Authority of another country.

## Overall Process Complexity

* + - * 1. Comparability analysis looks simple in theory but in prac- tice 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 substan- tiating adjustments are all steps that require time and money. It is therefore important to put the need for comparability analyzes 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 proportion- ate 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.
        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. 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 judgement to determine whether particular comparables are reliable.

## B .2 .5 . Conclusion

* + - 1. Transfer pricing theory meets practice in comparability analysis — the translation of the arm’s length principle into the selec- tion of reliable comparables and of the appropriate transfer pricing method, eventually yielding the transfer price. This is all facilitated by comparability analysis.
      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 pric- ing method in the circumstances of the case. This part of the process is fact-based and requires the taxpayer or tax administration to demon- strate an understanding of how business operates.
      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 particu- larly 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 compara- ble to the taxpayer’s controlled transaction, or the possible use of data- bases from other countries.
      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 comparabil- ity 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 bench- marks (or comparables). The choices made in the course of this analysis have to be substantiated and the overall process has to be thoroughly documented.

Part B: Design Principles and Policy Considerations

* + - 1. It is essential to put the need for comparability analyzes into perspective given the extent of the compliance burden and costs that can arise to a taxpayer or tax administration in identifying possi- ble comparables and obtaining detailed information. Taxpayers and tax administrations should exercise judgment to determine whether particular comparables are reliable.
      2. Further, as noted in the introduction, the lack of compa- rables 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 inte- grated business models and of transactions involving unique intangi- bles 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 analyzes.

## B .3 . METHODS

**B .3 .1 . Introduction to Transfer Pricing Methods**

* + - 1. This part of the chapter describes several transfer pric- ing 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 from transactions between associated enterprises. The transaction between related enterprises for which an arm’s length price is to be established is referred to as the “controlled transaction”. The application of transfer pricing meth- ods helps assure that transactions conform to the arm’s length stand- ard. 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 deter- minative 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 pric- ing should automatically be regarded as not being at arm’s length and there may be no reason to impose adjustments.

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

* + - * 1. The selection of a transfer pricing method serves to find the most appropriate method for a particular case. Considerations involved in selecting a method can include: the respective strengths and weaknesses of each method; the nature of the controlled transac- tion; the availability of reliable information (in particular on uncon- trolled comparables) needed to apply the selected method; and the degree of comparability between the controlled and uncontrolled transactions.
        2. The starting point in selecting a method is an understand- ing of the controlled transaction (inbound or outbound), in particu- lar based on the functional analysis which is necessary regardless of which transfer pricing method is selected. The functional analysis is a major part of selecting the transfer pricing method as it helps:

To identify and understand the intra-group transactions;

To identify the characteristics that would make a particular transaction or function suitable for use as a comparable;

To determine any necessary adjustments to the comparables;

To check the relative reliability of the method selected; and

Over time, to determine if modification of the method is appro- priate because the transaction, function, allocation of risks or allocation of assets have been modified.

* + - * 1. The major components of a functional analysis are analyzes of the functions, assets and risks. The functional analysis is described and discussed in detail in Chapter B.2, at Paragraph B.2.3.2.7. . Appendix I provides examples of a functional analysis for a manufac- turing business and a distribution business. A summary is provided here for context in the case of selection of appropriate methods.
        2. The functions performed: The functional analysis describes the activities performed such as design, purchasing, inbound logistics, manufacturing, research and development (R&D), assembling, inven- tory management, outbound logistics, marketing and sales activities, after sale services, supporting activities, services, advertising, financ- ing and management, etc. The functional analysis must specify which party performs each activity and in case both parties are involved in performing an activity it should provide for the relevant differences; for example 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 activities that add most value must be identified and should be discussed in more detail.
        3. The risks undertaken: The functional analysis should iden- tify risks undertaken. Examples are: financial risk (currency, inter- est 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 polit- ical risk, reliability of customers, fluctuation in demand and prices) and product risk (product liability risk, warranty risk and costs and contract enforceability). A risk-bearing party would expect to have higher earnings than a non-risk bearing party, and will incur the expenses and perhaps related loss if and when risk materializes.

* + - * 1. The assets used or contributed: The functional analy- sis must identify and 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 substan- tial competitive advantage is often achieved by the 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, market- ing intangibles, etc.).**41**
        2. Interplay of above factors: Today, in a multinational group, 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 analyzes both more difficult and more necessary. The functional analysis can help iden- tify 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 analy- sis could highlight that situation and consider the legal allocation of risk and the economic substance of the transaction. Another exam- ple 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 situa- tion and consider which party bears the risk in legal terms and which party bears the risk according to the economic substance of the trans- action. The functional analysis typically includes a discussion of the industry in which the tested party operates, the contractual terms of

41 See Glossary for a definition of “marketing intangibles”; a term used extensively in the OECD Transfer Pricing Guidelines.

the transaction at issue, the economic circumstances of the parties and the business strategies they employ. The functional analysis helps to identify the operations that benefit a related party and require an arm’s length return.

* + - * 1. 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 prac- tice it is sometimes not possible to identify reliable 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 B.2.
        2. Solutions for cases where comparables are difficult to find may include the following:

Searching for comparables in other industries where such com- parable 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 com- pany conducts its business; and

Using industry analyzes (publicly available or conducted inter- nally by the company) to identify profit levels that can reason- ably 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.

* + - * 1. Intangibles: Among the factors to be considered to select the most appropriate method in the circumstances of the case it is important to determine which party has developed or acquired the intangibles used and in what capacity, which party has the legal owner- ship and which party receives the benefit of the intangibles. The party that developed the intangibles 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.**42**

## Choice of Available Methods

* + - * 1. There are two general categories of methods. “Traditional Transaction Methods”, consisting of the Comparable Uncontrolled Price, Cost Plus and Resale Price Methods. The “Transactional Profit Methods” consist of the Transactional Net Margin Method and the Profit Split Method. A number of jurisdictions also apply “other meth- ods” which are considered to provide arm’s length results; however, it needs to be ensured that such methods are consistent with the arm’s length principle.
        2. No preference for particular methods is being advocated in this Manual. The most suitable method should be chosen taking into consideration the facts and circumstances. The taxpayer should for example take into account the type of transaction, the functional analysis, comparability factors, availability of comparable transac- tions and the possibility of making adjustments to the data to improve comparability. For further discussion on this issue, see Chapter B.2.
        3. Once a method is chosen and applied, taxpayers are gener- ally 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 changes in the facts, functionalities or availability of data.

42 See Chapter B.5. on Intangibles.

## B .3 .2 . Traditional Transaction Methods

* + - 1. **Comparable Uncontrolled Price**
         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 compara- ble circumstances. The CUP Method may also sometimes be used to determine the arm’s length royalty for the use of an intangible asset. CUPs may be based on either “internal” comparable transactions or on “external” comparable transactions. Figure B.3.1 below explains this distinction in the context of a particular case study.

Figure B.3.1:

### Comparable Uncontrolled Price Method

Associated Enterprise 1

Associated Enterprise 2

Transaction #1 (Internal)

Unrelated Party C

Transaction #2 (Internal)

Transaction #3 (External)

Unrelated Party A

Unrelated Party B

Controlled transaction

Uncontrolled transaction

* + - * 1. Facts of the Case Study: The controlled transaction in this figure involves the transfer 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.
        2. In applying the CUP Method to determine whether the price charged for bicycles transferred in this controlled transaction is at arm’s length, the following information is assumed to be available for consideration:

The price charged for bicycles transferred in a comparable uncontrolled transaction between Associated Enterprise 1 and Unrelated Party C (i.e. transaction #1);

The price charged for bicycles transferred in a comparable uncontrolled transaction between Associated Enterprise 2 and Unrelated Party A (i.e. transaction #2); and

The price paid for bicycles transferred in a comparable uncon- trolled transaction between Unrelated Party A and Unrelated Party B (i.e. transaction #3).

* + - * 1. Comparable uncontrolled transactions, such as transac- tion #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 applica- tion 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 B.2.

## Comparability in Application of the CUP Method

* + - * 1. When applying the CUP Method, an uncontrolled trans- action 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 uncon- trolled transaction.

* + - * 1. 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 B.2. In determining the degree of comparability between the controlled transactions and uncontrolled transaction #1 in Figure

B.3.1, for example, the following factors should be taken into account:

1. characteristics of property being transferred or services provided,
2. 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.
   * + - 1. Product comparability should be closely examined in applying the CUP Method. A price may be materially influenced by differences between the goods or services transferred in the controlled and uncontrolled transactions. The CUP Method is appropriate espe- cially in cases where an independent enterprise buys or sells products that are identical or very similar to those sold in the controlled trans- action or in situations where services are rendered that are identical or very similar to those rendered in the controlled transaction.
         2. Although product comparability is important in apply- ing 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.
         3. Reasonably accurate adjustments may be possible for differences in:

The type and quality of the products. E.g. unbranded Kenyan as compared with unbranded Brazilian coffee beans;

Delivery terms. E.g. Associated Enterprise 1 in Figure B.3.1 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 trans- actions can be recognized.**43** The uncontrolled price can be

43 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 rea- sonably accurate adjustments for this difference.

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 1 sells 5000 bicycles to Associated Enterprise 2 for US$90 per bicycle, while it sells 1000 similar bicycles to Unrelated Party C. The effect of the differences in volume on price should be ana- lyzed, and if the effect is material adjustments should be made perhaps based on volume discounts in similar markets;

Product characteristics. E.g. the uncontrolled transactions to an unrelated party in Figure B.3.1 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 bicy- cles 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;

Risk incurred. 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 differ- ence 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 bicy- cles 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 transac- tions concerns the locale. To perform adjustments to account for this difference one might have to consider, for example, dif- ferences 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.

* + - * 1. Reasonably accurate adjustments may not be possible for:

Unique and valuable trademarks. E.g. assuming Associated Enterprise 1 in Figure B.3.1 is engaged in manufacturing high value branded goods, and attaches its valuable trademark to the goods transferred in the controlled transaction, while uncon- trolled 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 effect of the trademark on price since the trade- mark 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.

* + - * 1. 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. 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.

## Strengths and Weaknesses of the CUP Method

* + - * 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;**44**

44 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 Resale Price Method is used, the related party sales company is the tested party in the

Involves a direct transactional comparison of a similar transac- tion between unrelated parties. That is, it is a more direct meas- ure of the arm’s length price than the other methods, all of which indirectly determine arm’s length prices through evaluation 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.

* + - * 1. The weakness of the CUP Method lies in the difficulty of finding comparable uncontrolled transactions in the light of the compa- rability standards that must be observed, particularly with respect to the comparability of products, intellectual property or services.

## When to Use the CUP Method

* + - * 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 transac- tions 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 possi- ble to locate acceptable internal comparables and external compara- bles. Consequently, a question that should be asked in any analysis is whether one of the associated enterprises involved is engaged in trans- actions with independent enterprises.
        2. In the example represented in Figure B.3.1 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

transfer pricing analysis. If the Cost Plus Method 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 Transactional Net Margin Method.

is to determine the degree of comparability between the controlled and uncontrolled transactions based on the comparability factors.

* + - * 1. 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.
        2. 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 inde- pendent enterprise (i.e. an internal comparable is available). In such a case all relevant information on the uncontrolled trans- actions is available and it is therefore probable that all material differences between controlled and uncontrolled transactions will be identified; and

The transactions involve commodity type products, but the dif- ferences between the products are minor.

## Case Examples of Use of the CUP Method

### B .3 .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 trans- action 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 addition, the Comparable Uncontrolled Price 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 Comparable Uncontrolled Price Method will therefore provide the most direct and reliable measure of an arm’s length result.

**B .3 .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 mate- rial and cannot be reliably estimated. As there are material product dif- ferences for which reliable adjustments cannot be made the Comparable Uncontrolled Price Method is unlikely to provide a reliable measure of the arm’s length result.

### B .3 .2 .5 .3 . Example 3: Minor Product Differences

The facts are the same as in Example 1 except that MCO, which manu- factures 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 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.

**B .3 .2 .5 .4 . Example 4: Effect of Geographic Differences**

FM, a specialty radio manufacturer, sells its radios to a controlled dis- tributor, 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 differ- ences. 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 Comparable Uncontrolled Price 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 Comparable Uncontrolled Price Method may still provide the most reliable measure of an arm’s length result.

## Resale Price Method

* + - * 1. The Resale Price Method (RPM) is one of the traditional transaction methods that can be used to determine whether a trans- action reflects the arm’s length principle. The Resale Price Method 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 B.3.2 below.
        2. The Resale Price Method analyzes the price of a product that a related sales company (i.e. Associated Enterprise 2 in Figure B.3.2) 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 func- tions it performs and the risks it incurs. The remainder of the prod- uct’s price is regarded as the arm’s length price for the inter-company 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 Resale Price Method requires less direct transactional (product) comparability than the CUP Method.

Figure B.3.2:

### Resale Price Method

Arm’s length price?

Associated Enterprise 1

Given price

Given price

= US$100

Independent Enterprise

Associated Enterprise 2

Resale price margin (25%) = US$ 25

Arm’s length price = US$ 75

* + - * 1. 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 the following formula:

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

TP = the *Transfer Price* of a product sold between a sales com- pany and a related company;

RSP = the *Resale Price* at which a product is sold by a sales com- pany 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.

### B .3 .2 .6 .4 . Example of Resale Price Method Application

It is assumed that the resale price in Figure B.3.2 is $100. This means that Associated Enterprise 2 resells the bicycle to Independent Enterprise for $100. If we assume that an arm’s length gross profit margin that Associated Enterprise 2 should earn is 25%, Associated Enterprise 2 should cover its SG&A expenses and make an appropriate profit with this 25% 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 x (1-0.25).

B.3.2.6.5. Other approaches are possible. For example, if the associ- ated 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 func- tions performed, assets used and risks assumed by the reseller.

## Arm’s Length Gross Profit Margin

* + - * 1. The financial ratio analyzed under the Resale Price Method 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 of a sales company are the sales revenue obtained by 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 trans- fer price paid to the related manufacturer.

* + - * 1. Accounting consistency is extremely important in apply- ing the RPM. Gross profit margins will not be comparable if account- ing principles and/or practices differ between the controlled transaction and the uncontrolled transaction. For example, the comparable distribu- tors 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”. Therefore, appropriate adjustments should be applied to the data used in computing the gross margin to make sure that “similar” gross margins are compared.

## Transactional Comparison versus Functional Comparison

* + - * 1. The arm’s length price or margin can result from look- ing 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).
        2. The arm’s length (range of) gross profit margin(s) to be earned by the sales company in the controlled transaction can there- fore be determined in the following two ways:

By transactional comparison: For example, one could deter- mine 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 com- parable 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 transac- tions performing functions and incurring risks comparable to the functions performed and risks incurred by Associated Enterprise 2. Functional comparison thus involves a search for comparable distribution companies rather than comparable transactions. This could, for example, include comparable dis- tributors of wheelbarrows and carts.

* + - * 1. In practice, transactional comparisons are more likely to achieve broad product and accounting consistency than functional comparisons. This means that 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 Resale Price Method is used in those situations to determine the gross margin a sales company should earn over its full range of (aggregated) products.

## Comparability in Applying the Resale Price Method

* + - * 1. An uncontrolled transaction is considered comparable to a controlled transaction if:

There are no differences between the transactions being com- pared that materially affect the gross margin (for example, con- tractual terms, freight terms, etc.); or

Reasonably accurate adjustments can be performed to elimi- nate the effect of such differences.

* + - * 1. As noted above, the Resale Price Method is more typically applied on a functional than on a transactional basis so that func- tional comparability is typically more important than product compa- rability. Product differences will probably be less critical for the Resale Price Method 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 differ- ent activities.

* + - * 1. While product differences may be more acceptable in applying the Resale Price Method as compared to the CUP Method, the property transferred should still be broadly similar in the controlled and uncontrolled transactions. Broad differences are likely to reflect differences in functions performed, and therefore gross margins earned, at arm’s length.
        2. The compensation for a distribution company should be the same whether it sells washing machines or dryers; because the functions performed (including risks assumed and assets used) are similar for the two activities. It should be noted, however, that distrib- uters 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 Resale Price Method, 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 distrib- uted by the sales company. Instead, the Resale Price Method 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.
        3. As the gross profit margin remunerates a sales company for performing marketing and selling functions; the Resale Price Method especially depends on comparability regarding functions performed, risks assumed and assets used. The Resale Price Method thus focuses on functional comparability. A similar level of compensation is expected for performing similar functions 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, compa- rability adjustments should be performed on the gross profit margins of the uncontrolled transactions. The operating expenses in connec- tion with the functions performed and risks incurred should be taken into account in this respect, as differences in functions performed are frequently reflected in different operating expenses.
        4. The following issues should be considered in determining whether the functions performed by an uncontrolled entity are compa- rable to the functions performed by a controlled entity for purposes of applying the Resale Price Method:

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 differ- ences 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 exam- ple by assisting considerably in the creation or maintenance of intangible property 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 rela- tion to the resale activity itself, or if it employs valuable and unique assets in its activities (e.g. valuable marketing intangi- bles 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.

* + - * 1. It should be recognized that returns to similar functions may not be the same in different markets. Generally, reliability is enhanced when the reseller and the comparable companies are oper- ating in the same market.

## Strengths and Weaknesses of the Resale Price Method

* + - * 1. The strengths of the Resale Price Method 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 inelas- tic, the resale price may be more reliable; and

The method can be used without forcing distributors to inap- propriately “make profits”. The distributor earns an arm’s length gross profit margin, however, but could have operating losses due, for example, to high selling expenses caused by business strategies such as a market penetration strategy. By comparison, the application of the Transactional Net Margin Method, which analyzes a financial ratio based on operating profits, will gener- ally result in an arm’s length range of positive operating profits. The tested party in the analysis would then probably also earn a positive operating profit within the range. However, the Resale Price Method does not necessarily result in positive operating profits to be earned by the tested party.

* + - * 1. The weaknesses of the Resale Price Method 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).

## When to Use the Resale Price Method

* + - * 1. In a typical inter-company transaction involving a “fully-fledged” manufacturer (i.e. as compared, for example, with a limited risk company or contract manufacturer) owning valuable patents or other intangible properties and affiliated sales companies which purchase and resell the products to unrelated customers, the Resale Price Method is an appropriate method to use if:

The CUP Method is not applicable;

The sales companies do not own valuable intangible prop- erties; and

Reliable comparisons can be made on COGS.

* + - * 1. It is useful to again consider the example of Figure B.3.2. It assumes 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 Resale Price Method 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 Cost Plus Method (discussed below) will not be selected in this case, because:

The fully-fledged manufacturer (i.e. Associated Enterprise 1) owns valuable intangibles, performs R&D activities and gen- erally has operations that are more complex than those of the sales company (i.e. Associated Enterprise 2);

The results obtained from applying the Cost Plus Method will not be as reliable as the results obtained from applying the Resale Price Method using the sales company as the tested party; and

It will be very difficult, if not impossible, to identify manufac- turers comparable to Associated Enterprise 1 (i.e., that own comparable intangible properties) when applying the Cost Plus Method.

* + - * 1. The Resale Price Method will establish the transfer price by reference to the resale or gross margins (gross profit/net sales) earned by third party resellers (assuming that internal comparison is not

possible) and compare them to the gross margin earned by Associated Enterprise 2 on the bicycles purchased from related parties.

* + - * 1. The Resale Price Method may also be applied in a commis- sionaire/commission agent structure involving a principal and related commissionaires/commission agents. In this case, the Resale Price Method will establish an arm’s length commission to be earned by the commissionaires/commission agents.

## Case Examples of the Resale Price Method

### B .3 .2 .12 .1 . Example 1

A controlled taxpayer sells property to another member of its controlled group which resells the property in uncontrolled sales. It is for all practical purposes assumed that there are no changes in the beginning and ending inventory for the year under review. Information regarding an uncon- trolled comparable is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transac- tions have been identified and adjusted for. If the applicable resale price of the property involved in the controlled sale is $100 and the appropriate gross profit margin is 20%, then an arm’s length result of the controlled sale is a price of $80 ($100—(0.2%×$100)).

**B .3 .2 .12 .2 . Example 2**

SCO, a Country B corporation, is the distributor for FP, its foreign parent. There are no changes in the beginning and ending inventory for the year under review. SCO’s total reported cost of goods sold is $800, consist- ing 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 $1000

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%. Therefore, SCO’s appropriate gross profit is $250 (i.e. 25%

of the applicable resale price of $1000). As SCO is incur-ring 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 ($1000). 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 cost of sales of FP’s product in this case equals $550 (i.e., $750 minus

$200) and not $600.

### B .3 .2 .12 .3 . Example 3

FM, a foreign manufacturer, sells Product to UCO, its subsidiary in Country U, which in turn sells Product to its domestic affiliate BCO. BCO sells Product to unrelated buyers. In this case, the applicable resale price is the price at which BCO sells Product in uncontrolled transactions. The determination of the appropriate gross profit margin for the sale from UCO to BCO will take into account the functions performed by UCO and BCO, as well as other relevant factors.

**B .3 .2 .12 .4 . Example 4**

TCO, a Country T corporation, is the exclusive distributor of products for its foreign parent. To determine whether the gross profit margin of 25% earned by TCO is an arm’s length result, the local taxing authority con- siders 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 the uncontrolled transactions.

### B .3 .2 .12 .5 . Example 5

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 uncon- trolled 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 is available regarding the functions performed and risks borne by the uncontrolled distributors and the contractual terms under which they operate in the uncontrolled transactions. In addition, data is available to ensure accounting consistency between all of the uncontrolled distributors and RCO. As the available data is suffi- ciently complete and accurate to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified; such differences have a definite and reasonably ascertain- able effect; and reliable adjustments are made to account for such differ- ences, the results of each of the uncontrolled distributors may be used to establish an arm’s length range.

**B .3 .2 .12 .6 . Example 6**

The facts are the same as in Example 5, except that sufficient data is not available to determine whether any of the uncontrolled distributors pro- vide 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.

**B .3 .2 .12 .7 . Example 7**

The facts are the same as in Example 5, except that Product Z is branded with a valuable trademark that is owned 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 applica- tion 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 dif- ferences 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 may be included in determining the arm’s length gross margin.

## Cost Plus Method

* + - * 1. In a controlled transaction involving tangible property, the Cost Plus Method focuses on the related manufacturing company as the tested party in the transfer pricing analysis. The Cost Plus Method may also be used in the case of services rendered.
        2. The Cost Plus Method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate gross profit in light of the functions performed, risks assumed, assets used and market conditions.
        3. The Cost Plus Method is used to analyze transfer pricing issues involving tangible property or services. It is typically most applied to manufacturing or assembling activities and relatively simple service providers. The Cost Plus Method focuses on the related party manufac- turer or service provider as the tested party in the transfer pricing anal- ysis. The method evaluates the arm’s-length nature of an inter-company charge by reference to the gross profit mark-up on costs incurred by suppliers of property (or services) for tangible property transferred (or services provided). 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.

Figure B.3.3:

### Cost Plus Method

Associated Enterprise 2

Associated Enterprise 1

Arm’s length price?

|  |  |  |
| --- | --- | --- |
| 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 B.3.3. is $500. If it is assumed also that an arm’s length gross profit mark-up that Associated Enterprise 1 should earn is 50%, the resulting transfer price between Associated Enterprise 1 and Associated Enterprise 2 is $750 (i.e. $500 x (1 + 0.50)).

Like the Resale Price Method, the Cost Plus Method 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.

* + - * 1. Figure B.3.3. 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 and risks than Associated Enterprise 2, the analysis under the Cost Plus Method would focus on Associated Enterprise 1 as the tested party. Since Associated Enterprise 1 is a simple manufacturer, the Cost Plus Method may be the best method of analy- sis in this case. The Cost Plus Method analyzes whether the gross profit mark-up earned by Associated Enterprise 1 is at arm’s length by refer- ence to the gross profit margins earned by companies manufacturing comparable goods for (or providing comparable services to) unrelated parties. The Cost Plus Method 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.

## Mechanism of the Cost Plus Method

* + - * 1. Under the Cost Plus Method (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.
        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 manufactur- ing 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.

## Arm’s Length Gross Profit Mark- up for Cost Plus Method

* + - * 1. The financial ratio considered under the Cost Plus Method is the gross profit mark-up, which is defined as the gross profit to cost of goods sold ratio of a manufacturing company. As discussed above, gross profit equals net sales minus cost of goods sold. For a manufac- turing 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.
        2. As with the Resale Price Method, accounting consistency is extremely important in applying the Cost Plus Method. 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 compa- rable 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.
        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 manu- facture different products); and (3) operating expenses (e.g. SG&A

expenses). The gross profit margin used in the Cost Plus Method is a profit margin that is calculated by subtracting only the direct and indi- rect 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 will typically be more reliable than the Cost Plus Method, as discussed below.

### B .3 .2 .15 .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% on its cost of goods sold and classifies cer- tain expenses (like warranty expenses) as operating expenses that are not part of cost of goods sold. Four comparable independent manufac- turers are identified which earn gross profit mark-ups between 10% and 15%. However, these comparable companies account for those particular (warranty) expenses as cost of goods sold. The unadjusted gross profit mark-ups of these comparables are thus not calculated on the same basis as the gross profit mark-up of Associated Enterprise 1. Unless reliable adjustments may 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.

**B .3 .2 .16 . Transactional Comparison versus Functional Comparison**

* + - * 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).
        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 inde- pendent enterprise in a comparable uncontrolled transaction, which previously has been rejected as an internal comparable for purposes of applying the CUP Method because for exam- ple, it involves different models of bicycle. If for example the controlled transaction involves the manufacturing of recrea- tional 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.

* + - * 1. In practice, transactional comparisons are more likely to achieve the broad product and accounting consistency required for the Cost Plus Method than functional comparisons. In a transactional comparison, much more information about the controlled and uncon- trolled transactions is available (e.g. contractual terms). In a functional comparison that is based on information provided in publicly avail- able 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 compa- nies. Consequently, it would be more likely in these circumstances that a net margin method would be used, see below at para. B.3.3.2.
        2. Based on benchmarking and financial analyzes an arm’s length range of gross profit mark-ups earned by comparable inde- pendent 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.

### B .3 .2 .17 . Comparability

* + - * 1. An uncontrolled transaction is considered comparable to a controlled transaction in applying the Cost Plus Method if:

There are no differences between the transactions being com- pared that materially affect the gross profit mark-up; or

Reasonably accurate adjustments can be performed to adjust for the effect of such differences.

* + - * 1. As with the Resale Price Method, and for the same reasons, close similarity of products in the controlled and uncontrolled trans- actions is less important under the Cost Plus Method than under the CUP Method, while functional comparability (including compara- bility of risks assumed and assets used) is more important. However, because significant differences in products may necessarily result in significant differences in functions the controlled and uncontrolled transactions should ideally involve the manufacturing of products within the same product family.
        2. As the gross profit mark-up remunerates a manufactur- ing company for performing a manufacturing function, the Cost Plus Method necessarily requires functional comparability. If there are material differences in functions performed that affect the gross profit mark-ups achieved on the controlled and the uncontrolled transac- tions, 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 and risks incurred will be taken into account as differences in functions performed may be reflected in the operating expenses.

### B .3 .2 .18 . Determination of Costs

* + - * 1. Application of the Cost Plus Method 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 basis;

Differences between the tested party and comparables should be identified. In this respect, it is crucial to consider differ- ences in the level and types of expenses in connection with the

functions performed 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, how- ever, 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 basis. 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 calcu- lated uniformly by the associated enterprise and the independ- ent 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 Cost Plus Method. On the one hand using actual costs will better reflect the risks faced by the contract manufacturer.**45** On the other hand, third parties will usually use budgeted costs in selling products to 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 Cost Plus Method 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

45 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.

between the manufacturer or service provider and the pur- chaser of goods or services.

### B .3 .2 .19 . Strengths and Weaknesses

* + - * 1. The strength of the Cost Plus Method is that the method is based on internal costs, the information on which is usually readily available to the multinational enterprise.
        2. The weaknesses of the Cost Plus Method include the following:

There may be a weak link between the level of costs and the market price;

The data on mark-up gross margins may not be comparable due to accounting inconsistencies and other factors;

Accounting consistency is required between the controlled and uncontrolled transactions;

The analysis focuses only on the related party manufacturer; and

Since the method is based on actual costs, there may be no incentive for the controlled manufacturer to control costs.

### B .3 .2 .20 . When to Use the Cost Plus Method

* + - * 1. The Cost Plus Method is typically applied in cases involv- ing the inter-company sale of tangible property where the related party manufacturer performs limited manufacturing functions or in the case of intra-group provision of services. The method usually assumes the incurrence of low risks, because the level of the costs will then better reflect the value being added and hence the market price.
        2. The Cost Plus Method is also generally used in transac- tions involving a contract manufacturer, a toll manufacturer or a low risk assembler which does not own product intangibles and incurs little risk. The related customer involved in the controlled transaction will generally be much more complex than the contract manufacturer 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 produc- tion, and purchasing raw materials in some cases), risks incurred (e.g.

market risk, credit risk and inventory risk) and assets owned (product intangibles). The contract manufacturer is thus the less complex and as such should be the tested party in the transfer pricing analysis.

* + - * 1. The Cost Plus Method is usually not a suitable method to use in transactions involving a fully-fledged manufacturer which owns valuable product intangibles as it will be very difficult to locate independent manufacturers owning 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 owning the product 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 least complex entities involved in the controlled transactions and will therefore be the tested party in the analysis. The Resale Price Method is typically more easily applied in such cases.

## B.3.2.21. Case Examples of Cost Plus Method

### B .3 .2 .21 .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 is available regarding the functions performed and risks borne by UT1, UT2, and UT3, and the contractual terms in the uncontrolled transactions. In addition, data is available to ensure accounting consistency between all the uncontrolled manufacturers and LCO. As the available data is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncon- trolled transactions have been identified, the effect of the differences is definite and reasonably ascertainable, and reliable adjustments are made to account for the differences, an arm’s length range can be established.

**B .3 .2 .21 .2 . Example 2**

The facts are the same as in Example 1 except that LCO accounts for super- visory, 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 is not sufficient to determine whether such accounting differences exist between the controlled and uncontrolled transactions the reliability of the results will decrease.

### B .3 .2 .21 .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 rea- sonably ascertain the effect of the difference on the gross profit mark-ups will affect the reliability of the results of UT1, UT2, and UT3.

**B .3 .2 .21 .4 . Example 4**

FS, a foreign corporation, produces apparel for PCO, its parent corpora- tion. 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 is available regarding the functions performed and risks borne by the uncontrolled producers. In addition, data is suf- ficiently detailed to permit adjustments for differences in accounting practices. However, sufficient data is 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 inabil- ity 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.

## B .3 .3 . Transactional Profit Methods

* + - 1. **Introduction**
         1. This part of the chapter discusses transactional profit methods, which analyze the profits arising from particular controlled transactions in order to determine whether a transfer price is at arm’s length. Transactional profit methods can be divided into two catego- ries; the Transactional Net Margin Method (TNMM) and the Profit Split Method (PSM).
         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 (the earnings determined before interest and tax and extraordinary items, i.e. EBIT) realized by vari- ous companies engaged in a particular line of business (that is, a series of transactions that are appropriate to be aggregated). Among other situations, these methods may be applied when one or more of the associated enterprises contributes valuable intangible assets (such as technology intangibles) in performing transactions with other associ- ated enterprises and the appropriate return for the use of those intan- gible assets must be determined.
         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 by independent enterprises in otherwise compa- rable circumstances. Where complexities make the application of the traditional transaction methods addressed in the previous chapter unre- liable, transactional profit methods may prove to be a good solution.
         4. Transactional profit methods and particularly the Transactional Net Margin Method are also commonly used by taxpay- ers for practical reasons. The Transactional Net Margin Method often provides a useful check on the accuracy and reasonableness of the traditional transaction methods or is used to supplement these meth- ods. It is also easier to find comparables in applying the Transactional Net Margin Method.

## Transactional Net Margin Method

* + - * 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 Cost Plus Method and Resale Price Method. The party examined is referred to as the tested party.
        2. The TNMM compares the net profit margin**46** (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 independ- ent comparable companies. As it uses net margins to determine arm’s length prices the TNMM is a less direct method than the Cost Plus Method and Resale Price Method 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.
        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 intangi- ble assets, the appropriate return to which cannot be determined directly. In such a case the arm’s length compensation of the associ- ated enterprise(s) not employing the intangible asset is determined by determining the margin realized by enterprises engaged in a simi- lar function with unrelated parties. The remaining return is conse- quently 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

46 For example, return on total costs, return on assets, and operating profit to net sales ratio.

and uncontrolled transactions. In addition, the tested party typically does not own valuable intangible property.

## Definition and Choice of Tested Party

* + - * 1. The application of the TNMM is similar to the applica- tion of the Cost Plus Method or Resale Price Method, but the TNMM requires less product comparability than these methods and involves comparison of net rather than gross profit margins. Figure B.3.4 below and the paragraphs following it illustrate this distinction.**47**

Figure B.3.4.

**Transactional Net Margin Method**

|  |  |  |
| --- | --- | --- |
| Given price | = | $**10 000** |
| Cost of goods sold | = | $\_\_\_\_\_? |
| Gross profit | = | ? |
| Operating expenses | = | $ 2 000 |
| Net profit (5% of price) | = | $ 500 *Comparable* |

Associated Enterprise 1, a bicycle manufacturer in Country 1, sells bicy- cles to Associated Enterprise 2 which resells the bicycles to the inde- pendent 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. 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 Cost Plus Method and Resale Price Method may be considered.

* + - * 1. The Cost Plus Method 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 1 owns valuable intangible property, the resale price could be considered. Under the Resale Price Method, the sales company, the least complex of the two entities involved in the controlled transaction, will be the tested party. The analysis would entail a search for distributors which

47 All figures and numeric examples are for practical purposes only. They do not reflect actual cases or actual arm’s length figures or margins.

sell broadly similar products, which perform functions and incur risks comparable to those of Associated Enterprise 2, and for which appro- priate data relating to gross profits can be obtained.

* + - * 1. 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 Resale Price Method 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.
        2. 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 the related party manufacturer as the tested party could be, for example, the situation in which Associated Enterprise 1 is a contract manufacturer. In such a case, the contract manufacturer will typically be the least complex entity as MNEs often separate the ownership of valuable technology intangibles from the manufactur- ing function. The Cost Plus Method would normally be considered if the CUP Method cannot be applied. However, due to the account- ing 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).

## Mechanism of the Transactional Net Margin Method

* + - * 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 Resale Price Method and Cost Plus Method as can be seen in the following examples.
        2. Related party distributor: In applying the Resale Price Method 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 a benchmarking analysis. The transfer price or cost of goods sold of the related party distributor is the unknown vari- able. Assuming a resale price of $10,000 and a gross profit margin of 25%, the transfer price amounts to $7,500:

Table B.3.1:

**Mechanism of the Resale Price Method**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Initially** | **Benchmarking analysis** |  |
| Resale price | $10 000 | $10 000 |  |
| Cost of goods sold | ? | 7 500 |  |
| Gross profit | ? | 2 500 | (25% of resale price) |

* + - * 1. The determination of an arm’s length transfer price based on the TNMM is more or less similar. The main difference from a gross margin analysis is that operating expenses are considered in calcu- lating 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)**48** 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%, 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%:

* + - * 1. Related party manufacturer: In applying the Cost Plus Method 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 trans- fer 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%, the transfer price amounts to $7,500:

48 Net profit equals operating profit before interest and taxes.

Table B.3.2:

**Mechanism of the Transactional Net Margin Method**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **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) |

* + - * 1. In applying the TNMM to the tested party manufacturer instead of the Cost Plus Method, the cost of goods sold and the oper- ating expenses of the related party manufacturer are known. A bench- marking 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, oper- ating expenses of $1,000 and an arm’s length net profit to total cost ratio of 25%, the transfer price amounts to $7,500. Table B.3.4. illus- trates 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 B.3.3:

**Mechanism of the Cost Plus Method**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **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) |

Table B.3.4:

**Mechanism of the Transactional Net Margin Method**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **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) |

## Examples49

### B .3 .3 .5 .1 . Example 1: Transfer of Tangible Property Resulting in No Adjustment

FP is a publicly traded Country A corporation with a Country B subsidi- ary named BCO that is under audit for its 2009 taxable year. FP manufac- tures 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.

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 | 4 600 | 98 200 |
| Operating profit | 27 000 | 37 600 | (4 600) | 20 000 |

49 The examples below derive from the US Internal Revenue Service Intercompany Transfer Pricing Regulations, available from [https://www.irs.](https://www.irs.gov/pub/irs-apa/482_regs.pdf) [gov/pub/irs-apa/482\_regs.pdf](https://www.irs.gov/pub/irs-apa/482_regs.pdf).

There is data from a number of independent operators of wholesale dis- tribution 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 rela- tively stable where at least three years are included in the average. For the taxable years 2007 to 2009, BCO shows the following results:

After adjustments have been made to account for identified material dif- ferences 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 following comparable operating profit (COP) for BCO:

The data is 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 inter- quartile range, which extends from COP observation 19,760 to 34,840.

|  |  |  |
| --- | --- | --- |
| **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 |

### B .3 .3 .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 fol- lowing 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 |

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 allocation may be appropriate. To determine the amount, if any, of the allocation, 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 compa- rables and applied to US Sub’s 2009 sales to derive the following results: 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.

|  |  |  |
| --- | --- | --- |
| **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 |

### B .3 .3 .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 aver-age results from the uncontrolled comparables and average sales for BCO for the years 2008 to 2010, ranges from $15,500 to $30,000. In deter-mining whether an allocation for the 2007 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 oper- ating 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 allocation may be appropriate. To determine the amount, if any, of the allocation for the 2010 taxable year, the taxing authority compares BCO’s reported operating profit for 2010 to the median of the comparable oper- ating profits derived from the uncontrolled distributors’ results for 2010. The median of the comparable operating profits derived from the uncon- trolled 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.

### B .3 .3 .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 exam- ines whether the royalty rate of 5% 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 deter- mines 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 vari- ety 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 Country M and N pro- vide the best match of companies in a similar market performing similar functions and bearing similar risks. Such data is sufficiently complete to identify many of the material differences between HCO and the uncon- trolled comparables and to make adjustments to account for such differ- ences. However, data is 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 Country 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 determines that an allocation may be appropriate for the 2009 taxable year.

To determine the amount, if any, of the allocation 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).

### B .3 .3 .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 identi- fied. 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.

**B .3 .3 .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, ten 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.

## Arm’s Length Net Profit Margin

* + - * 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 “profit level indicators” the net profitability of the controlled transaction is compared to the net profitability of the uncontrolled transactions.

Table B.3.5:

**Overview of Profit Level Indicators**

|  |  |
| --- | --- |
| Return on Assets (ROA) | Operating profit divided by the oper- ating 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 |

* + - * 1. 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 deduc- tion for 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.

* + - * 1. Although all of the above PLIs are possible, the three PLIs:

1. 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.**50** An OM is typically used for marketing, sales and distribution activities; a Berry ratio may sometimes be used for service of distribution activities; and full cost plus, ROCE or ROA are typi- cally 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 compa- nies. This type of PLI may be the most reliable if the tangible operating assets have a high correlation to profitability. For example, a manu- facturer’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

50 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 and risks assumed, should be proportional to the operating expenses; (ii) the value of the functions performed, taking into account assets used 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 per- form other significant functions in the transaction under examination that should be remunerated using another method or profit level indicator.

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 while the ROCE focuses on the amount of debt and equity capital that is invested in the company.

* + - * 1. Other PLIs listed above are ratios between income state- ment 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 not close to those of the comparables, since differences in function have less effect on operating profit than on gross profit.
        2. The Berry Ratio represents a return on a company’s value added functions on the assumption that these value added func- tions are captured 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 oper- ating 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. However, some key limitations of the Berry Ratio are:

The Ratio is very sensitive to functions and classifying of cost as operating cost;

It misses values of cost needed to maintain the intangible prop- erty of an entity; and

Its reliability diminishes if asset intensities (the efficiency with which assets are used) of the entities differ

* + - * 1. 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 manipula- tion, making comparisons between the tested party and comparables difficult or impossible.
        2. 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 diver- gence between the different PLIs it may be useful to examine impor- tant functional or structural differences between the tested party and the comparables.

## Transactional Comparison Versus Functional Comparison

* + - * 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; and

Functional comparison: the net profit margins enjoyed by inde- pendent companies performing functions and incurring risks comparable to those of the tested party.

* + - * 1. Much more detailed information will be available with respect to the controlled and uncontrolled transactions if a transac- tional comparison is possible, because the related parties involved have participated in these transactions. The degree of comparability can then be analyzed more carefully than in a functional comparison in which only public information is available (e.g. business descrip- tions 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.
        2. 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 B.3.6. The TNMM is applied and the profit level indicator is the operating margin. A benchmarking anal- ysis is performed, identifying four comparable independent distrib- utors considering the comparability standard of the TNMM. The arm’s length range of operating margin earned by these comparable

distributors falls between 2% and 6%. Because the operating profit margin earned by the related party distributor falls within this range (e.g. 4%), its transfer price is considered to be at arm’s length.

Table B.3.6:

**Functional Comparison Example**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **Compar- able A** | **Compar- able B** | **Compar- able C** | **Compar- able 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% |

## Comparability

* + - * 1. Product comparability is most important in applying the CUP Method, as differences in products will result in different prices. The Cost Plus Method and the Resale Price Method are less depend- ent on product comparability and focus on functional comparability because differences in functions that are reflected in differences in oper- ating expenses may lead to a broad range of gross margins. However, the TNMM is even less dependent on product comparability and func- tional 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.
        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.
        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 adjust- ments should be made to account for such differences.

## Other Guidance for Application of the Transactional Net Margin Method

* + - * 1. The TNMM is less reliable when applied to the aggregate activities of a complex enterprise engaged in various different trans- actions 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 gener- ally 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 TNMM when the aggregate activities/transactions are sufficiently interlinked, as for example when similar sales func- tions are conducted for products in similar product lines.
        2. The TNMM should be applied using transactions or func- tions of independent enterprises that are comparable to the controlled transactions or functions being examined. Furthermore, results attrib- utable to transactions between the tested party and independent enter- prises should be excluded when evaluating controlled transactions. The latter point is illustrated in Table B.3.7 below. In this example, the Related Party Distributor purchases products from both the Related Party Manufacturer and an Unrelated Manufacturer and resells these prod- ucts 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 distribu- tors earn an operating profit margin between 2% and 6%.

* + - * 1. The tax authorities apply the TNMM to the profit and loss statement (P&L) of the Related Party Distributor as a whole. The oper- ating profit margin earned by Related Party Distributor is 2% based on aggregate transactions and therefore falls within the arm’s length range. The aggregated transactions appear to be at arm’s length. However, if the TNMM was applied only to the controlled transactions the conclusions would be very different. The operating profit margin earned by Related Party Distributor on the controlled transactions is minus 3%, which falls outside the arm’s length range of comparables and merits an adjustment. It appears from the P&L that in this example the controlled transactions generated operating losses, which resulted in lower consolidated results for the company as a whole. Consistency is important in quantifying these amounts. Net margins should be calculated uniformly between the tested party and the independent enterprises.
        2. An analysis considering multiple year data is better able to take into account the effects on profits of product life cycles and short-term economic conditions, but different countries may take differ- ent views about when multiple year data should be analyzed and indeed whether that is allowed under a country’s domestic law. Use of an arm’s length range should also be considered, to reduce the effects of differ- ences 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.

Table B.3. 7:

**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 |
| Operating expenses | 13 000 | 15 000 | 28 000 |
| Operating profit | (3 000) | 7 000 | 4 000 |
| Operating profit margin | -/- 3% | 7% | 2% |

## Strengths and Weaknesses of the TNMM

### B .3 .3 .11 .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 mar- gins. Product and functional comparability are thus less critical in applying the TNMM;
* Less complex functional analysis is needed, as TNMM is applied to only one of the related parties involved;
* Because TNMM is applied to the less complex party, it can be used even though one of the related parties holds intangible assets for which comparable returns cannot be determined;
* The TNMM is applicable to either side of the controlled trans- action (i.e. to either the related party manufacturer or the dis- tributor); and
* The results resemble the results of a modified Resale Price Method or Cost Plus Method of analysis.

### B .3 .3 .11 .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 infor- mation on profits attributable to uncontrolled transactions;
* Measurement challenges, these may make it difficult to deter- mine 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 will also be very difficult to allocate sales revenue, operating expenses and 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;

* 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 Cost Plus Method and Resale Price Method 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.

## When to Use the Transactional Net Margin Method

* + - * 1. TNMM is usually applied with respect to broad compara- ble functions rather than particular controlled transactions. Returns to these functions are typically measured by a PLI in the form of a net margin that arguably will be affected by factors unrelated to arm’s length pricing. Consequently, one might expect the TNMM to be a rela- tively disfavoured method. Nevertheless, TNMM is typically applied when two related parties engage in a continuing series of transactions and one of the parties controls intangible assets for which an arm’s length return is not easily determined. Since TNMM is applied to the party performing routine manufacturing, distribution or other func- tions that do not involve control over such intangible assets, it allows the appropriate return to the party controlling unique or difficult-to- value intangible assets to be determined indirectly.
        2. TNMM may also be appropriate for use in certain situa- tions in which data limitations on uncontrolled transactions make it more reliable than traditional methods. TNMM may be more attrac- tive if the data on gross margins are less reliable due to accounting differences (i.e. differences in the treatment of certain costs 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.
        3. Consider the example in Table B.3.8 below, where the related party distributor earns a gross profit margin of 20% while the comparable distributor earns a gross profit margin of 30%. Based on the Resale Price Method 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. 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 enter- prises cannot be obtained from publicly available information. It may then be more appropriate to perform a net margin method of analy- sis where such accounting inconsistency has been removed. The result of applying the TNMM is that the net profit margin of 10% for the related party distributor is similar to that of the comparable distrib- utor. The transfer price is therefore considered to be at arm’s length based on the TNMM.
        5. Also, if the available comparables differ significantly with respect to products and functions, making it difficult to reliably apply the Cost Plus Method or Resale Price Method, it may be more appro- priate to apply the TNMM because net margins are less affected by such differences. For example, in performing a benchmarking analysis

for the purposes of the Cost Plus Method or Resale Price Method it may appear that exact product and functional comparables cannot be found. In fact, the comparables differ substantially regarding prod- uct and functional comparability. In such a case the TNMM might be more reliably applied using such comparables.

Table B.3.8:

**Accounting Differences: The Resale Price Method as Compared with the Transactional Net Margin Method**

|  |  |  |
| --- | --- | --- |
|  | **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 |

* + - * 1. Finally, TNMM may be attractive if the data is 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 using the return on total costs as the profit level indicator.
        2. In addition to the three situations mentioned above, the TNMM is also used in practice by tax authorities to identify compa- nies for an audit by analysing 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 Resale Price Method to determine an arm’s length compensation for a distribution company.

## Profit Split Method

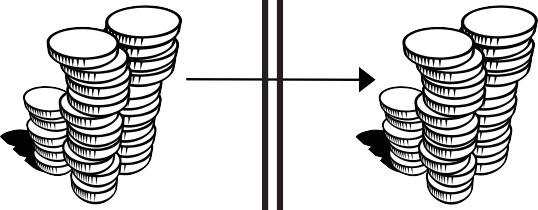
* + - * 1. The Profit Split Method is typically applied when both sides of the controlled transaction contribute significant intangi- ble property. The profit is to be divided such as is expected in a joint venture relationship.
        2. The Profit Split Method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transac- tion (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. Figure B.3.5 illustrates this.

Figure B.3.5:

### Profit Split Method

Associated Enterprise 1

Associated Enterprise 2



* + - * 1. The Profit Split Method starts by identifying the profits to be divided between the associated enterprises from the controlled trans- actions. Subsequently, these profits are divided between the associated enterprises based on the relative value of each enterprise’s contribu- tion, which should reflect the functions performed, risks incurred and assets used by each enterprise in the controlled transactions. External market data (e.g. profit split percentages among independent enterprises performing comparable functions) should be used to value each enter- prise’s contribution, if possible, so that the division of combined profits between the associated enterprises is in accordance with that between independent enterprises performing functions comparable to the func- tions performed by the associated enterprises. The Profit Split Method is applicable to transfer pricing issues involving tangible property, intan- gible property, trading activities or financial services.

## Methods to Allocate or Split the Profits

* + - * 1. There are generally considered to be two specific methods to allocate the profits between the associated enterprises: contribution analysis and residual analysis.
        2. Under the contribution analysis the combined profits from the controlled transactions are allocated between the associated enterprises on the basis of the relative value of functions performed by those associated enterprises engaged in the controlled transactions. External market data that reflect how independent enterprises allocate the profits in similar circumstances should complement the analysis to the extent possible.
        3. If the relative value of the contributions can be calcu- lated directly, then determining the actual value of the contribution of each enterprise may not be required. The combined profits from the controlled transactions should normally be determined on the basis of operating profits. However, in some cases it might be proper to divide gross profits first and subsequently subtract the expenses attributable to each enterprise.
        4. Under the residual analysis the combined profits from the controlled transactions are allocated between the associated enter- prises based on a two-step approach:

*Step 1*: allocation of sufficient profit to each enterprise to pro- vide basic arm’s length compensation for routine contributions. This basic compensation does not include a return for possible valuable intangible assets owned by the associated enterprises. The basic compensation is determined based on the returns earned by comparable independent enterprises for comparable transactions or, more frequently, functions. In practice TNMM is used to determine the appropriate return in Step 1 of the residual analysis; and

*Step 2:* allocation of residual profit (i.e. profit remaining after Step 1) between the associated enterprises based on the facts and circumstances. If the residual profit is attributable to intan- gible property then the allocation of this profit should be based on the relative value of each enterprise’s contributions of intan- gible property.

* + - * 1. The residual analysis is typically applied to cases where both sides of the controlled transaction contribute valuable intangi- ble property to the transaction. For example, Company X manufac- tures components using valuable intangible property and sells these components to a related Company Y which uses the components and

also uses valuable intangible property to manufacture final products and sells them to customers. The first step of a residual analysis would allocate a basic (arm’s length) return to Company X for its manufac- turing function and a basic (arm’s length) return to Company Y for its manufacturing and distribution functions. The residual profit remain- ing after this step is attributable to the intangible properties owned by the two companies. The allocation of the residual profit is based on the relative value of each company’s contributions of intangible prop- erty. The OECD Guidelines do not refer to specific allocation keys to be used in this respect. Step 2 may not, and typically does not, depend on the use of comparables.

* + - * 1. The following approaches have been specified in some jurisdictions to determine the relative value of each company’s contri- butions of intangible property:

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;**51** and

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.

* + - * 1. The Residual Profit Split Method 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 functions based on comparables. The second step analyzes returns to (often unique) intangible assets based not on comparables but on rela- tive value which is, in many cases, a practical solution. Secondly, poten- tial 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.

51 A disadvantage of this approach is that cost may not reflect the market value of the intangible property.

## Comparable Profit Split Method

* + - * 1. A different version of the Profit Split Method is used in some countries. In this version the profit is split by comparing the allo- cation of operating profits between the associated enterprises to the allocation of operating profits between independent enterprises partic- ipating in similar activities under similar circumstances (Comparable Profit Split Method). The major difference with the contribution anal- ysis is that the Comparable Profit Split Method depends on the availa- bility of external market data to measure directly the relative value of contributions, while the contribution analysis can still be applied even if such a direct measurement is not possible.
        2. The contribution analysis and the Comparable Profit Split Method are difficult to apply in practice and therefore not often used. This is especially the case because the reliable external market data necessary to split the combined profits between the associated enter- prises are often not available.

## Strengths and Weaknesses

* + - * 1. The strengths of the Profit Split Method include:

It is suitable for highly integrated operations for which a one-sided method may not be appropriate;

It is suitable in cases where the traditional methods prove inap- propriate due to a lack of comparable transactions;

The method avoids an extreme result for one of the associated enterprises involved due to its two-sided approach (i.e. all par- ties to the controlled transaction are being analyzed); and

This method is able (uniquely among commonly used transfer pricing methods) to deal with returns to synergies between intangible assets or profits arising from economies of scale.

* + - * 1. The weaknesses of the Profit Split Method include:

The relative theoretical weakness of the second step. In par- ticular, the theoretical basis for the assumption that synergy value is divided pro rata to the relative value of inputs is unclear (although this approach is arguably consistent with the way interests are divided between participants in a joint venture);

Its dependence on access to data from foreign affiliates. Associated enterprises and tax administrations may have dif- ficulty obtaining information from foreign affiliates; and

Certain measurement problems exist in applying the Profit Split Method. It may be difficult to calculate combined revenue and costs for all the associated enterprises taking part in the con- trolled transactions due to, for example, differences in account- ing practices. It may also be hard to allocate costs and operating expenses between the controlled transactions and other activi- ties of the associated enterprises.

## When to Use the Profit Split Methods

* + - * 1. The Profit Split Method might be used in cases involving highly interrelated transactions that cannot be analyzed on a sepa- rate basis. This means that the Profit Split Method can be applied in cases where the associated enterprises engage in several transactions that are so interdependent that they cannot be evaluated on a sepa- rate basis using a traditional transaction method. In other words, the transactions are so interrelated that it is impossible to identify compa- rable transactions. In this respect, the Profit Split Method is applica- ble in complex industries such as, for example, the global financial services business.
        2. The (Residual) Profit Split Method is typically used in complex cases where both sides to the controlled transaction own valu- able intangible property (e.g. patents, trademarks and trade names). If only one of the associated enterprises owns valuable intangible prop- erty, the other associated enterprise will be the tested party in an analy- sis using the cost plus, resale price or transactional net margin methods. However, if both sides own valuable intangible properties for which it is impossible to find comparables, then the Profit Split Method might be the most reliable method. A practical example would be where Company A designs and manufactures electronic components and transfers the components to a related Company B which uses them to manufacture an electronic product. Both Company A and Company B use innovative technological design to manufacture the components and electronic product, respectively. Company C, a related Company, distributes the electronic products. Assuming that the transfer price between Company B and Company C is at arm’s length based on the

Resale Price Method, the Residual Profit Split Method is applied to determine the arm’s length transfer price between Company A and Company B because both companies own valuable intangible property.

* + - * 1. In step 1 of the residual analysis, a basic return for the manufacturing function is determined for Company A and Company

1. Specifically a benchmarking analysis is performed to search for comparable independent manufacturers which do not own valuable intangible property. The residual profit, which is the combined profits of Company A and Company B after deducting the basic (arm’s length) return for the manufacturing function, is then divided between Company A and Company B. This allocation is based on relative R&D expenses which are assumed to be a reliable key to measure the rela- tive value of each company’s intangible property. Subsequently, the net profits of Company A and Company B are calculated in order to work back to a transfer price.
   * + - 1. The Profit Split Method involves the determination of the factors that bring about the combined profit, setting a relative weight to each factor and calculating the allocation of profits between the associated enterprises. The contribution analysis is difficult to apply, because external market data that reflect how independent enterprises would allocate the profits in similar circumstances is usually not avail- able. The first step of the residual analysis often involves the use of the TNMM to calculate a return and is not, in itself, more complicated than the typical application of TNMM. The second step is, however, an additional step and often raises difficult additional issues relating to the valuation of intangibles.

## Examples: Application of Residual Profit Split

1. 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 cloth- ing and headgear (Stelon). XYZ obtains patent protection for the chemical formula for Stelon. Since its introduction, Stelon has cap- tured a substantial share of the market for bulletproof material.
2. 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.

* 1. XYZ-Asia’s research unit alters Stelon to adapt it to military specifi- cations and develops a high-intensity marketing campaign directed at the defence industry in several Asian countries. Beginning with the 2009 taxable year, XYZ-Asia manufactures and sells Stelon in Asia through its marketing network under one of its brand names.
  2. For the 2009 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 2009 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, Country A’s taxing authority determines that a residual profit split will provide the most reli- able measure of an arm’s length result. Based on an examination of a sample of Asian companies performing functions similar to those of XYZ-Asia the district director determines that an aver- age market return on XYZ-Asia’s operating assets in the Stelon business is 10%, resulting in a market return of $20 Million (10% x

$200 Million) for XYZ-Asia’s Stelon business, and a residual profit of $180 Million.

* 1. Since the first stage of the residual profit split allocated profits to XYZ-Asia’s contributions other than those attributable to highly valuable intangible property, it is assumed that the residual profit of $180 Million is attributable to the valuable intangibles related to Stelon, i.e. the Asian brand name for Stelon and the Stelon for- mula (including XYZ-Asia’s modifications). To estimate the relative values of these intangibles the taxing authority compares the ratios of the capitalized value of expenditures as of 2009 on Stelon-related research and development and marketing over the 2009 sales related to such expenditures.
  2. 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 busi- ness activities to which they relate. The taxing authority determines 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, the taxing authority capitalizes and amortizes XYZ’s protective product research and development expenses. 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 2009 tax year.

1. 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 the taxing authority capitalizes and amortizes XYZ-Asia’s expenditures and determines that they have a value in 2009 of $0.40 per dollar of XYZ-Asia’s Stelon sales.
2. 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 2009, of which XYZ contributed a third (or $0.20 per dollar of sales). Accordingly, the taxing authority determines that an arm’s length royalty for the Stelon license for the 2009 taxable year is $60 Million, i.e. one-third of XYZ-Asia’s

$180 Million in residual Stelon profit.

## B .3 .4 . The “Sixth Method” or “Commodity Rule”

* + - 1. **Introduction**
         1. Transfer pricing rules require associated enterprises to price their intercompany transactions in accordance with the arm’s length principle. The five methods set forth in Chapters B.3.2 and B.3.3 (Transfer Pricing Methods) of this Practical Manual are used to calcu- late or test the arm’s length nature of intercompany prices or prof- its earned from intercompany transactions. As set forth in Chapter B.3.1.2.1, 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 trans- actions of the same or similar products are available. For instance, the quoted prices of the commodities market may be comparable uncon- trolled prices for transactions with commodities performed by related parties under comparable circumstances.
         2. Tax authorities may find themselves unable to successfully determine whether a controlled transaction between associated enter- prises is comparable with uncontrolled transactions observed in the market if the taxpayer does not provide sufficient supporting docu- mentation 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 trans- fer pricing studies.
         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 of the commodi- ties market to price commodity transactions between associated enter- prises. For practical purposes, in this Section the approach will be referenced as the “sixth method”.**52**
         4. Because of its widespread application, this Section discusses the rationale for and country experiences with the “sixth method”. Its inclusion in this Section, however, does not seek to address the rela- tionship 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. In addition, it generally considers certain characteristics and substance requirements, as defined in relevant domestic practices, for the sixth method to be applicable to a particular transaction. Absent reliable and timely confirmation from the taxpayer about the relevant charac- teristics 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

52 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.

commodity price listing used). Despite its more general title, consider- ing 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 a form of safe harbour. Some countries consider the sixth method an (imperfect) application of the CUP method.**53** This Section will refer to the practice as “the sixth method” without address- ing whether the term method, anti-abuse rule or abuse-deeming rule or safe harbour is more appropriate or legally more correct.

* + - * 1. 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 are that it is not one of the traditional transactions methods or traditional profit methods described in this Chapter and thus may not be recognized by the country of the associ- ated enterprise at the other end of the transaction; its inaccuracy consid- ering the general standard application of the arm’s length principle; that the method does not consider the economic circumstances of the actual transaction that is tested; and that the method may result in overcom- pensation of one associated enterprise at the detriment of another asso- ciated enterprise and therefore potential double taxation. Benefits and disadvantages are discussed further in paragraph B.3.4.3.3.1 infra.
        2. This chapter describes the so-called sixth method as it is observed in practice in several countries. It also discusses OECD guid- ance 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 description of the application of the so-called sixth method in case of commodity transactions and describes what steps can be taken to mitigate some identified disadvantages of using the sixth method.

## The Sixth Method

### B .3 .4 .2 .1 . Practical Operation

At the date of drafting this Section, the method in issue is in place in countries such as Argentina, Bolivia, Brazil, Costa Rica,

53 Brazil applies a similar sixth method approach to loan operations. For details, see Chapter D.1

Dominican Republic, Guatemala, Honduras, Peru, Uruguay and some Caribbean countries. To date, practical experience with the rule exists in mainly in Argentina, Brazil, Ecuador and Uruguay.**54** However, it should be noted that the method is not applied unequivocally the same 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.

The fact pattern traditionally targeted by the sixth method is one where associated enterprises engaged in the business of export- ing 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 also is at a later point in time than the date of the original sale between the associated enter- prises and the intercompany 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).

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 jurisdic- tion, there is risk that the associated trading entity transaction serves to erode the tax base of the associated seller of the commodities. This can be done by paying an intercompany 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 intercompany price by refer- ence 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

54 According to CIAT, the rule may be in place in several countries but practical experience with application of the rule is still quite limited.

sixth method in some countries specifies that the intercompany sales price will be deemed to be the higher of either the intercompany sale date or the sales price 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.

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:**55**

Table B.3.9.

**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 administra- tions 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 |

55 Table 3.9. is from CIAT-GIZ’s research and (a forthcoming) publica- tion on the sixth method.

|  |  |
| --- | --- |
|  | parties may be established in some coun- tries, 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), regard- less 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 estab- lished 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 differ- ent 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:   1. 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 agree- ment 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 circum- stances, contract terms and conditions, and product quality and specifications whereas other countries no not accept comparability adjustments. |
| **Exceptions to applying the measure** | Some measures implemented in the region provide the local taxpayer with the pos- sibility to evidence that the intermediary has economic substance, even though the criteria are not the same in every case. |

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 intercompany transactions are not abusive and the prices are at arm’s length, and the method allows comparability adjust- ments as need be, it may be more generally consistent with the arm’s length principle and provide for legal certainty. It can also help with providing the tax authorities more transparency as regards the inter- company transaction between the associated enterprises.

## OECD and CIAT Guidance

### B .3 .4 .3 .1 . OECD Guidance

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 espe- cially applicable to commodity transactions.**56** The new guidance includes a clarification of the existing guidance on the application of the comparable uncontrolled price (CUP) method to commodity transactions. The new guidance states that:

the CUP method would generally be an appropriate trans- fer pricing method for commodity transactions between associated enterprises;

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 trans- action; and

reasonably accurate adjustments should be made, when needed, to ensure that the economically relevant character- istics of the controlled and uncontrolled transactions are sufficiently comparable.

The new guidance also includes a new provision on the determination of the pricing date for commodity transactions that provides under certain conditions 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 lead- ing 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) similar to the sixth method.

56 See OECD. (2015), *Aligning Transfer Pricing Outcomes with Value Cre- ation, Actions 8-10 —2015 Final Reports.* OECD/G20 Base Erosion and Profit Shifting Project. OECD Publishing, Paris.

In addition, the guidance developed under other BEPS Actions is also relevant in dealing with issues relating to commod- ity transactions. In particular, the revised standards for transfer pric- ing documentation and the guidance in the chapter “Guidance for Applying the Arm’s Length Principle.” This guidance is expected to be supplemented with further work mandated by the G20 Development Working Group, following reports by the OECD on the impact of base erosion and profit shifting (BEPS) in developing countries. The outcome of this work will provide knowledge, best practices and tools for commodity-rich countries in pricing commodity transactions for transfer pricing purposes.

Tax authorities in developing countries may find it easier to test the arm’s length nature of intercompany commodity transac- tions 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:**57**

* documentation on the price-setting policy for commodity transactions;
* the information needed to justify price adjustments based on the comparable uncontrolled transactions or comparable uncon- trolled 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 informa- tion prepared for non-tax purposes.

The date of pricing commodity transactions is particularly relevant in determining whether such transactions between associated enterprises are priced appropriately. Tax administrations should deter- mine 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 transaction. Such evidence should include:

57 See para. 2.16D of the OECD’s Transfer Pricing Guidelines’ section on Commodity Transactions, *ibid*.

* the time the transaction was entered into (e.g. proposals and acceptances, contracts or registered contracts, or other docu- ments 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.

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 adminis- trations 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 indus- try 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 appropri- ate 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 pric- ing date through access to the mutual agreement procedure under the applicable Treaty.**58**

### B .3 .4 .3 .2 . CIAT Guidance

CIAT has conducted a study to analyze the operation of the so-called sixth method ten years after its introduction in Argentina.**59** In particular, it conducted a comparative analysis of the implementation of the sixth method in other Latin American countries. The study notes

58 See para. 2.16E of the OECD’s Transfer Pricing Guidelines’ section on Commodity Transactions, *ibid*.

59 Hereafter referenced as “the CIAT study.”

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 encountered is the difficulty in assessing useful and timely information for carrying out such a comparison.

The CIAT study notes that authorities may react differ- ently 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 corpo- rate terms. Other authorities may wish to make use of transfer pricing rules and determine the intercompany price that should apply by elim- inating 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 considera- tion 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.

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 applica- tion of a treaty for the avoidance of double taxation. That is, to the extent it 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 conse- quences of its application and to the extent it is seen as being a domes- tic 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.

The workings of the sixth method originally serve to help set a tax base and collect (corporate) tax. The method is most often

applied to export and/or import of commodities based on intercom- pany commodity transactions and applies the publicly available value of the commodity on the actual date of shipment as price-setting moment. The method generally disregards whether the buyer or seller pays for the shipment and at what date delivery of the goods finally takes place. The method may also apply a crude comparability, in that the grade or quality of the commodity and sometimes even the volume shipped may be inexact. However, some countries and author- ities 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 export and imports regardless of (i) foreign intermedi- aries and/or (ii) the involvement of associated intermediaries.

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 commod- ity and its subsequent processing or transformation, to help with deter- mining the arm’s length compensation for the functions performed and risks incurred by the entities involved in that value chain.

### B .3 .4 .3 .3 . Considerations for use of the sixth method

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 trans- fer 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 intercompany 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 double taxation. Another disadvantage of the approach is that it does not apply a traditional transaction method or traditional profit based method and hence may not be recognised

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 allow countries to achieve greater consistency with the arm’s length principle.

Further, it should be unequivocally clear in what situ- ations the approach applies; this will avoid disadvantaging taxpay- ers and will foster legal certainty. If a (lack of) substance test applies it should provide clear and objective criteria. In that situation, only when the taxpayer clearly fails to meet the substance test should the sixth method approach be applied. Potential double taxation resulting from application of the sixth method approach can also be a disadvan- tage. 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 avoidance of double taxation under an applicable treaty.

Publicly available prices may be based on standardized agreements setting forth basic aspects of the transaction, such as qual- ity, 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 characteristics such as physical charac- teristics 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 trans- action between the associated enterprises is carried out at the same level of the supply chain as the one that served to set the publicly avail- able price.

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 on the substance of (their associated) interme- diary entities and based on adequate evidence can opt out of the appli- cation of the sixth method, it could be expected that taxpayers will

make an effort to provide the requisite additional information and the more accurate and arm’s length the income allocation may become that applies between the associated enterprises.

Allowing for evidence or proof of substance is not uncom- mon 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, demon- strates effective presence in the jurisdiction of residence, having a commercial office or premises where the business is managed, comply- ing 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 economical group – the multinational; (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.”

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 avoidance of 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 requi- site substance in the other jurisdictions. Second, taxpayers could be allowed to provide evidence that their intercompany pricing is at arm’s length and appropriate and reasonable adjustments to publicly avail- able commodity prices could be allowed in order to reflect possible transaction- and product differences. This is important as commod- ity prices are known to fluctuate significantly and be highly dependent on grade, quality and specifics of the respective commodity plus that import/export conditions are likely to influence the prices.

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 crite- ria for its application will assist in reducing uncertainty and potential tax disputes. To the extent taxpayers can provide evidence as regards to the needed substance of intermediaries and what would consti- tute an arm’s length price, the legislation includes adjustments to the publicly available commodity prices to assure improved comparabil- ity, 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.

## B .4 . INTRA-GROUP SERVICES

**B .4 .1 . Introduction**

* + - 1. This chapter considers the transfer prices for intra-group services within an MNE group. Firstly, it considers the tests for deter- mining whether chargeable services have been provided by one or more members of an MNE group to one or more associated enterprises for transfer pricing purposes. Secondly, if chargeable intra-group services have been provided, it considers the methods for determining 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.
      2. Under the arm’s length principle, if a chargeable intra-group service has been provided to associated enterprises, arm’s length transfer prices should be charged to group members receiv- ing or expected to receive an economic benefit from the services. The term “associated enterprises” is defined at Article 9(1) of the United Nations Model Double Taxation Convention between Developed and Developing Countries. It includes a parent company and its direct and indirect subsidiary companies. The test for determining whether chargeable intra-group services have been provided between associ- ated enterprises is whether one or more associated enterprises have received or are expected to receive an economic benefit from the activ- ity. 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 chap- ter as the “benefit test” and is considered in more detail below (paras. B.4.2.3 – B.4.2.6).
      3. A transfer pricing analysis of intra-group services should be considered from both the perspective of the service-provider and of the associated enterprise receiving the services. Tax authorities may

view the provision of intra-group services from either the perspec- tive of a service provider or of a recipient of services. The tax author- ity of the service provider would seek to ensure that if chargeable intra-group 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 intra-group 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 arm’s length consideration if the benefits test has been satisfied.

* + - 1. On the other hand, the tax authority of the recipient would be seeking to ensure that the services in question satisfy the bene- fit test and that the recipient was being charged arm’s length prices for the intra-group services. A tax authority of the service recipient would consider making an adjustment if it considered that the services provided a benefit to the recipient but that the service charges were excessive. Given the scale of business operations of an MNE group, service costs incurred and service charges may reflect significant amounts and any misallocation of service costs or charges within an MNE will affect the profit or loss allocations among group members.
      2. It should be noted that the requirement that chargea- ble 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 trans- fer prices for chargeable services. Principles of domestic law are then applied to determine if such payments may be deducted by the associ- ated 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.
      3. MNE groups in a globalized economy may have highly integrated business operations. The associated enterprises comprising such groups may seek business advantages from exploiting informa- tion, technology and communications systems and other assets on a combined basis. Intra-group services may play an important role in

MNE groups as they seek to obtain services at the lowest price to main- tain or improve their competitive position. Transfer pricing analyzes of such service relationships should recognize that MNE groups seek to maximize their profitability and competitive positions and they do not generally incur costs without a business purpose.

* + - 1. Many of the services that MNE groups 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 neces- sary 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 MNE groups 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 a benefit.
      2. Most intra-group services are easily identifiable, such as human resources services. 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 intra-group services may also be provided in conjunction with or embedded in intangibles or other assets.

## B .4 .2 . Analysis of Intra-Group Services

### Types of intra-group services

* + - 1. Many types of intra-group services may be provided between the associated enterprises comprising an MNE group. 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.”**60** A detailed list at the end of this chapter (drawn up by the European Commission) sets out some of the types of intra-group services. The list is intended

60 United Nations Conference on Trade and Development, *World Invest- ment Report 2004: The Shift towards Services* (Geneva: United Nations, 2004),

p. 145. Available from <http://unctad.org/en/docs/wir2004_en.pdf>

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 paras. B.4.5.3 –B.4.5.10) while a full transfer pricing analysis may be required for other services.

* + - 1. The profit margin which an associated enterprise may derive under the arm’s length principle from providing intra-group services varies. A lower profit mark-up is derived from low value-adding services such as administrative services. Such services are necessary for the efficient operation of the international operations of an MNE group but they do not create significant value for the MNE group. On the other hand, services associated with an MNE group’s core busi- ness activities, which are incurred to maintain or improve the MNE group’s profitability, viability or market position, may create greater value and carry a higher profit margin.

### The benefit test

* + - 1. The benefit test is used to determine whether a member of the MNE group has received a chargeable service from an associated enterprise. The benefit test has two requirements both of which must be satisfied. Secondly, the associated enterprise must demonstrate that an independent entity in the same or similar circumstances would have been prepared to pay for the services or perform the services itself. Once the benefit test has been satisfied, there remains the ques- tion of the arm’s length price for the service (see para. B.4.3.1).
      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 intra-group service. The level of detail covered by such a factual examination, and the amount and nature of docu- mentation required to demonstrate satisfaction of the benefit test, should be based on the materiality of the service charges.
      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 group to be

used by associated enterprises operating as fully fledged distributors with the expectation that all designated associated enterprises will bene- fit 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 group 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 as to these associated enter- prises only if an independent distributor would be expected to pay for the marketing services under similar circumstances.

* + - 1. 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 intra-group 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, intra-group 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 circum- stances 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.

### Service activities for the specific needs of an associated enterprise

* + - 1. Associated enterprises may request the provision of specific intra-group services. Services provided specifically to one member of the MNE group and designed specifically to its opera- tions will generally satisfy the benefit test. For example, an associated enterprise which is part of an MNE group involved in telecommunica- tions 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 group 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.
      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 enter- prise 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 associ- ated 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.

### Centralized services

* + - 1. An MNE group will often centralize certain business func- tions within an associated enterprise operating as a service provider to the rest of the group or to a sub-group of associated enterprises, such as a regional sub-group, for their benefit. A wide variety of services may be centralized in this manner, including both low and high-value- adding services. Depending on the facts, each associated enter- prise benefitting from the services provided by a centralized service provider should be charged an arm’s length price for the services it acquires. The economic benefit is apparent if an associated enterprise would otherwise have to perform the activity itself or engage an exter- nal service provider.
      2. There are numerous reasons for an MNE group to provide intra-group services on a centralized basis. Services may be provided by an associated enterprise for the rest of the group in order to mini- mize costs through economies of scale. This may allow the MNE group 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 group which may also involve the creation of centres of excellence. Some MNE groups may central- ize services in a regional management company for associated enter- prises 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 provid- ing the same type of services across a wider geographic or functional grouping of entities. Another potential benefit of having centralized services for an MNE group is the certainty that such services will be

available when required and that the quality of the services is consist- ent within the MNE group.

### Example 161

An MNE group 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 coun- tries are provided with the option of calling staff by telephone to book travel and receive advice where necessary. The MNE group decides to create a centralized call centre for the MNE 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 group operates. The call centre can operate on a 24 hour basis in providing call services to all time zones in which the MNE group carries on business. The MNE group concludes that centralizing call centre functions in its subsidiary in Country E will allow the group to take advan- tage 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.

### On-call services

* + - 1. Intra-group 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 group 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,

61 The examples contained in this chapter are some illustrations of the principle being considered.

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 neces- sary staff to provide the service, even during times when the poten- tial 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 asso- ciated 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.

### Non-chargeable activities

* + - 1. Certain intra-group service activities do not meet the bene- fit test for one or more associated enterprises, and so would not warrant charges. It is emphasized that a determination of whether an intra-group service has been provided to a particular associated enterprise depends on an analysis of the facts and circumstances of each case. The follow- ing section deals with four situations in which the benefit test is not met.

### Shareholder activities

* + - 1. 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 of share- holder. 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.
      2. Shareholder activities may include the following:
         * the preparation and filing of reports required to meet the juridi- cal 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 invest- ment in subsidiary companies.
      1. 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 share- holder expenses and in that case the cost cannot be attributed to asso- ciated enterprises. In this situation, the only enterprise in an MNE group 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 group 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.
      2. 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 recog- nizable benefits to members of an MNE group 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.
      3. Another example of a shareholder expense is the cost of obtaining financing by the parent of an MNE group 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 headquar- ter company to acquire a new company, this activity can be a chargea- ble financial service. 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.

### Example 2

Controller Co is a resident of Country A and it is the parent company of an MNE group (group). 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 finan- cial position periodically. The reporting requirements include the group’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 func- tion 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 group’s consolidated financial statements.

The incorporation of this material into Controller Co’s consoli- dated financial statements are actions that Controller Co carries out as a shareholder of Subsidiary Co, Controller Co cannot impose a service charge on Subsidiary Co for reviewing and incorporating its financial statements into the group’s consoli- dated financial statements that Controller Co is required to file, as these activities do not provide Subsidiary Co with a bene- fit. 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 group’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

* + - 1. 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 inde- pendent 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.
      2. At times an MNE group may engage in service functions which have the same name but the functions are performed at different levels and therefore do not involve duplication. These functions may be carried out at group, regional or local level. For example, strategic marketing functions are performed at 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.

### Example 3

Company X, resident in Country X, is part of an MNE group. 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 intra-group 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 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.

* + - 1. When an activity is in the process of being centralized for an MNE group, acceptable duplication may occur during the transition phase. For example, an MNE group 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 situa- tion an independent entity would have a period of duplication if it were in the process of outsourcing its human resources function to an inde- pendent service provider. Nevertheless, care should be taken in deter- mining whether a situation involves acceptable duplication.

### Example 4

Subsidiary Co, a company resident in Country A, is part of an MNE group (the group). The group’s business is grow- ing 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 func- tion 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 availa- ble either in-house or externally. A functional analysis indi- cates 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 opera- tions and Parent Co is performing the same treasury functions for Subsidiary Co. Accordingly, Parent Co’s treasury activi- ties 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.

### Example 5

An MNE group has its Parent Company in Country A. Parent Company performs treasury functions for itself and its subsid- iaries. The treasury functions include raising capital, obtain- ing 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 duplica- tion as Subsidiary Company does not perform treasury func- tions. In this case, Subsidiary Company is considered to obtain a benefit from the functions performed by Parent Company.

### Example 6

An MNE group has a parent company called Controller Company in Country A. Controller Company has in-house legal advisers with expertise in intellectual property. The exper- tise 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 nego- tiate. 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 agree- ment 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. Both Country A and Country B have similar legal systems. Parent Company uses its in-house legal coun- sel to provide advice on whether Property Company is enti- tled 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 has the comfort of the second opinion. In this situation there is no duplication and the use of a second legal opinion is a justified measure for dealing with a dispute with a customer. Independent entities involved in legal disputes may seek a second opinion to confirm their legal rights.

### Passive association

* + - 1. Benefits to members of an MNE group may arise as a result of an associated entity’s membership of the MNE group. Such benefits are attributable to the entity’s passive association with the MNE group. The benefits of association with an MNE group are not a chargeable service for members of the MNE group. 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. 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 enter- prise 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 enter- prise with a formal guarantee.
      2. Under these circumstances, the associated enterprise’s membership of the MNE group does not result in a chargeable service being provided to the associated enterprise by the MNE group. 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 group. In contrast, if a member of an MNE group provided a formal

guarantee of an associated enterprise’s trade credit, the formal guar- antee may be a chargeable service provided that an independent entity would have been willing to pay for a formal guarantee in similar circum- stances. 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 group members commit to additional purchases from that supplier.

* + - 1. The passive association of an associated enterprise with its MNE group may improve the associated enterprise’s credit rating. There are circumstances where an associated enterprise that is part of an MNE group may be able to receive a higher credit rating from lend- ers on the basis of its membership in the MNE group. For example, if the associated enterprise were assessed on a stand-alone basis, 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 group. In this situation there is no chargea- ble 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 asso- ciated enterprise, the parent would be actively seeking the advantage of a lower finance charge for the associated enterprise and the guarantee would, accordingly, qualify as a chargeable service for transfer pricing purposes requiring the payment of an arm’s length guarantee fee.

### Incidental benefits

* + - 1. There are other situations in which one associated enter- prise may provide an intra-group service to another associated enter- prise 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. Whether follow-on benefits to other group members may support the payment of service fees by the incidental beneficiaries depends on the facts. The determi- nation of whether a service fee should be paid by the incidental benefi- ciaries of the service depends on whether an independent party in the same circumstances would have been willing to pay for the intra-group service. In some cases, the incidental follow-on benefits that an asso- ciated enterprise receives may be remote and would fail the benefit test as an independent party would not be willing to pay for the service.

### Example 7

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 depart- ment is asked for assistance and advice as to how to make the associated enterprise in Country A profitable. After studying the Country A 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 requir- ing 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 motor- cycles of MNE X are less likely to be involved in deadly acci- dents. 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 developed for it by Parent company. As a result of the independent study on motorcycle safety, however, the sales of MNE X motorcycles go up in coun- tries B, C and D as well. These countries also have no laws that require the use of motorcycle helmets when riding a motorcy- cle. 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.

### Example 8

Assume that an MNE group has an Asia Pacific regional head- quarters company that requests the management of its parent company to review the structure and operations of associ- ated enterprises in that region to ensure the regional group

maintains its profitability. The managerial review of the associ- ated 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 technolog- ical developments. In this situation, the review would satisfy the benefit test at the level of the regional holding company. An inde- pendent 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 enter- prises which are regional headquarters in other regions, such as South America. If the business lines of the associated enter- prises 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.

There are some cases where a service performed by a group member benefits or is expected to benefit only certain group members, but incidentally provides benefits to other group members. Examples could be analyzing the question of whether to reorganize the group, to acquire new members, or to termi- nate a division. These activities could constitute intra-group services to the particular group members involved, for exam- ple, those members who will make the acquisition or termi- nate one of their divisions, but they also may produce economic benefit for other group members not involved in the decision by increasing efficiencies, economies of scale or other syner- gies. The incidental benefits ordinarily would not cause these other group members to be treated as receiving an intra-group service because the activities producing the benefits would not be ones for which an independent enterprise ordinarily would be willing to pay.

## B .4 .3 . Determining an arm’s length charge

### Functional analysis

* + - 1. If chargeable intra-group services have been rendered, the next step is to determine the arm’s length service charges for trans- fer pricing purposes. Under the arm’s length principle, charges for the services should reflect the charges that would be paid by independ- ent 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 to the service provider.
      2. As can be seen from a review of the types of services listed in the example 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 group. 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 appropri- ate in all situations. Specifically, cost plus methods will not always yield the best estimate of the arm’s length value of the services provided.
      3. To determine an arm’s length charge for intra-group services, a functional analysis should be undertaken. The functional analysis would consider the functions performed by the service provider, the assets used by it and the risks borne by it. 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 recipi- ent and it would also provide assistance in determining the reliability

of the 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 a separate chapter.

* + - 1. An example of a chargeable service activity would be the provision of marketing services for an MNE group by an associated enterprise. The functional analysis of that activity may involve an anal- ysis 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 may include the business premises as well as an office and computer equipment. The intangibles involved may include knowledge of inde- pendent enterprises providing advertising services, customer lists and know-how developed through other marketing campaigns. A market- ing strategy may involve an element of risk as a prediction can only be made on the expected outcomes of the campaign.

### Charging approaches

* + - 1. There are two general approaches that may be used in charging for services, the direct charge and the indirect charge.
      2. The direct charging method 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 method. For example, an overseas subsidiary may be directly charged for a 2-day visit of a software engineer who is employed by the parent company and who may have visited the overseas subsidiary’s site at the latter’s request to render certain consultancy services or advisory services. In such a case the parent company can charge the specific costs for these consulting services with or without a mark-up (as the case may be) directly to the foreign subsidiary.
      3. A direct charging method may be difficult to apply and the cost of direct charging may be an administrative burden which is disproportionate to the services provided. Many MNEs have

developed indirect charging methods using an apportionment method to reflect the relative benefit that each associated enterprise is expected to receive from the provision of intra-group services. Allocation keys used by MNE groups are based on objective factors which are proxy measures for the relative economic benefit an associated enterprise receives from centralized services. The allocation keys are considered at paras. B.4.4.15. – B.4.4.21. Allocation keys are acceptable provided they reasonably comply with the arm’s length principle. The main feature of indirect methods 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 to apportion the expenses. For example, if human resources services are centralized for an MNE group, the allocation may be based on the number of employees in each associ- ated enterprise. For services related to marketing, an objective basis for allocating expenses may be turnover.

* + - 1. At times it may be difficult to measure the expected economic benefit of some centralized services within an MNE group. For example, it would be difficult to estimate the benefit of a promotional campaign at a major national sporting event which has a worldwide tele- vision audience. Once the promotion rights are obtained and a payment made, the MNE group is required to allocate the cost of the central- ized promotion prospectively on the basis of the expected economic benefit for group members. Tax administrations of developing coun- tries often find it difficult to verify the validity of these types of fees. Furthermore, determining whether the applied allocation is in accord- ance with the arm’s length principle is another practical difficulty since intra-group services are mostly charged by applying an indirect charge method, 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 intra-group services structure. Potential 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.
      2. Generally, the direct charge method is preferred over the indirect charge method in cases where the services rendered by an

associated enterprise to other group members can be specifically iden- tified and quantified. In many circumstances, MNEs will not have an option but to use indirect cost allocation. In such cases, intra group services charged on an allocation basis will be acceptable if the allo- cation is a reasonable reflection of the expected benefits (see para. B.4.4.15.).

### Provision of assets and ancillary services

* + - 1. It may be necessary to distinguish between the trans- fer of tangible or intangible assets and services as the transfer agree- ment may include the provision of ancillary services. The services may include the provision of training or advice on the use and opera- tion of machinery and equipment. In the case of intangible assets, the services may be training and assistance on the use of patents, copy- right or know-how. If the provision of intra-group services is separate to the provision of tangible or intangible assets then it may be appro- priate for an arm’s length service charge to be allocated to the recipient. Determining whether a service is connected to the transfer of tangi- ble or intangible assets depends on the facts and circumstances of the transaction.
      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. Nevertheless, it may be diffi- cult to obtain external comparables. On the other hand, if the trans- fer price for the transfer of a tangible or intangible asset did not cover the provision of services, it would be appropriate for a service charge to be made.

### Example 9

Crimson Co is a resident of Country A and is the parent of an MNE group that carries on a business of mining and process- ing minerals. Violet Co is an associated enterprise resident in Country B and also carries on a business of mining and process- ing minerals. Crimson has developed a processing system for

minerals which reduces the cost of processing minerals and the processing time. The processing system is know-how and Crimson has not sought a patent for the processing system. 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 3% of Violet’s sales income from sales of minerals to independent customers.

Under this arrangement Crimson agrees to provide ancillary services to the staff of Violet Co on the use of the know-how. Assume that a functional analysis has been carried out by Crimson Co and appropriate comparables have been identi- fied in setting the 3% royalty fee. In addition, the comparables provide the same or similar ancillary services, the fees for which are embedded in the royalty fee. In this situation, Crimson has been fully remunerated for the provision of know-how and any ancillary services in the 3% royalty fee. It would be inap- propriate for the tax authority in Country A to claim that the royalty payment only applies to the licence arrangement and that Crimson Co is required to receive a further payment for the provision of ancillary services. The fees for the ancillary services are embedded in the transfer price of the know-how. Consequently, it would be inappropriate for any additional service charges for training to be imposed on the associated enterprise.

## B .4 .4 . Calculating arm’s length consideration

* + - 1. For both direct and indirect charging methods, the trans- fer pricing methods in this Manual (Chapter B.3) may be used to deter- mine arm’s length prices for intra-group services provided that they are reliable. If there is a disagreement between the tax authorities of the service provider and the service recipient on intra-group service charges, double taxation may occur. See Chapter B.3 for a detailed discussion of the transfer pricing methods that can be appropriate for intra-group services, i.e. the Comparable Uncontrolled Price (CUP) method, the Cost Plus Method, the Transactional Net Margin Method (TNMM) and, in some circumstances of high value added services providing integrated benefits, the Profit Split Method (PSM).

### CUP

* + - 1. The CUP method (see Chapter 3, paras. B.3.2.1.1 ff.) requires a high degree of comparability between controlled and uncontrolled transactions. If an MNE group’s service provider renders the same services in comparable circumstances to independent enti- ties as it provides to associated enterprises, these may qualify as inter- nal 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 intra-group members, external CUPs may in some cases be availa- ble. An external CUP may be used provided it is comparable to the intra-group services. However, for the CUP method to be applicable, an analysis of the types of services provided in controlled and uncon- trolled transactions is required.
      2. The CUP method may not be applicable if services are only provided within an MNE group and there are no comparable uncon- trolled 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 5. As the CUP method requires a high degree of comparabil- ity, details on the services rendered, functions performed, assets used and the risks borne in controlled and uncontrolled transactions may be needed. In addition, comparability may be affected if provision of the services involves the use of intangible assets. Other comparability factors may have an effect on the prices charged in uncontrolled trans- actions such as quantity discounts and contractual terms which may provide extended periods for payment of services rendered and associ- ated guarantees.
      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 and risks borne by the parties) will be available for comparison. This type of informa- tion on uncontrolled transactions is often confidential and unlikely to be publicly available.

### Example 10

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 approx- imately 60% of its business is made up of performing shipping services to these independent customers and 40% of its business is performing 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 comparabil- ity in terms of the type of service provided, the volume of trans- actions, the contractual terms and the economic conditions. In this case, Shipper would be able to use the internal compara- bles in setting its transfer prices for shipping services provided to Grain Co.

### Example 11

Assume the same facts as Example 10, except that 90% of Shipper Co’s business is providing shipping services for Grain Co. The remaining 10% 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 independ- ent shipping enterprises. In these situations, shipping services may be more costly than when there is no shortage. In this situ- ation, the comparability analysis is likely to lead to the conclu- sion that the comparables need to be adjusted for the significant differences between the controlled and uncontrolled transac- tions which would affect the shipping charges.

The main differences on the facts are the volume of business (90% of volume originated by Grain Co and 10% by independ- ent entities) and the regularity of providing grain transport- ing 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.

### Cost Plus Method

* + - 1. In practice, it is often the case that the CUP method is inapplicable. In this situation, an MNE group may consider using the Cost Plus Method, which is less dependent on similarity between the controlled and uncontrolled service transactions than the CUP. As stated at para. B.3.2.13.3, the financial ratio considered under the Cost Plus Method is the gross profit mark-up. The aim of the Cost Plus Method is to set the appropriate cost plus mark-up on cost base so that the gross profit in a controlled services transaction is appropri- ate in the light of the functions performed, risks assumed, assets used and market conditions. The Cost Plus Method focuses on the service provider as the tested party. The Cost Plus Method is used to deter- mine arm’s length service charges based on the gross profit mark-up on costs earned by comparable independent service providers. The Cost Plus Method is often used for determining transfer prices for services.
      2. Although the Cost Plus Method is less dependent on simi- larity between the controlled and uncontrolled services under the CUP method, the services in controlled transactions and compara- ble uncontrolled transactions should be similar. If material differences arise between the controlled transactions and the comparables, adjust- ments are required provided they are reasonably accurate.
      3. The cost base of services for controlled and uncontrolled transactions should be comparable. The application of the Cost Plus Method depends on ensuring that the cost base of the associated enterprise and the comparables is the same as there is the possibil- ity of differences between the cost bases arising from the use of differ- ent indirect expenses in the cost base. A list of the types of direct and

indirect costs is set out below at para. B.4.4.9. Differences between the cost bases can arise from the use of different indirect expenses in the cost and may make the Cost Plus Method unreliable.

* + - 1. While in principle the appropriate mark-up for the Cost Plus Method should be based on available comparables from inde- pendent service providers, as a matter of simplicity it may be appro- priate to use the safe-harbour option for administrative services considered below. The cost of finding appropriate comparables for the purposes of the cost plus method 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.

### Total service costs: direct and indirect costs

* + - 1. Total services costs means all costs in calculating the oper- ating 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 communica- tion expenses attributable to the provision of services. Indirect expenses may include the following items: depreciation of equipment and build- ings; rent for leased items or immovable property; property taxes; occu- pancy and other overhead costs; maintenance costs; insurance; personnel costs, accounting and payroll expenses; and other general, administra- tive and managerial expenses. Total services costs do not include inter- est expenses, foreign income taxes or domestic income taxes.

### Example 12

A company that is a member of an MNE group 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 capi- tal 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 include these expenses in the prices it charges its customers.

### Transactional Net Margin Method (TNMM)

* + - 1. The TNMM may be used for services. (See Chapter 3, paras

B.3.3.2.1. - B.3.3.2.3. 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 that the associated enterprise enters into. Alternatively, the profit margins may be obtained from transactions by independent parties.

* + - 1. The TNMM may be used for intra-group services if the Cost Plus Method 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 trans- actions is different. As the method is based on net profit levels, the TNMM has a greater tolerance for accounting inconsistencies aris- ing from cost base differences between controlled and independent service providers.
      2. The profit level indicator that may be appropriate for intra-group 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 carry- ing on comparable activities may be available and may provide reliable comparables to be used in applying the TNMM.

### Example 13

Service Provider Co in Country A is a member of an MNE group and it provides marketing services for the group. Service

Provider is requested by an associated enterprise Seller Co in Country B to design a marketing program for a new prod- uct. Following research, Service Provider has concluded that the CUP and Cost Plus Methods are inapplicable. In applying the TNMM to Service Provider, the costs of providing services and operating expenses are known. The unknown variable is the arm’s length charge for the intra-group service. A compa- rability analysis is then carried out to determine the appropri- ate arm’s length net profit margin for Service Provider. If we assume that the cost of providing the service is $80,000 and the operating expenses are $20,000, the total direct and indi- rect costs of providing the services are $100,000. Assume that Service Provider makes a net profit to costs of 5%. A search of comparable independent marketing enterprises has revealed they are making a net profit to costs of providing services of 3%-8%. 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. In this situation, Service Provider’s net profit of 5% 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 intra-group services to an associated enterprise.

### Profit Split Method

* + - 1. The Profit Split Method may in certain circumstances be used for services (see Chapter 3, para. B.3.3.13.1. and following, 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 associ- ated enterprises engaging in controlled transactions. The Profit Split Method is usually used when both sides to controlled transactions contribute significant intangible property. The aim of this method is to allocate profits on the basis that independent enterprises would have used in comparable independent transactions. Under the Profit Split Method the profit derived from controlled transactions is allocated between the associated enterprises on the basis of each associated enterprise’s relative contributions. The relative contributions would be determined on the basis of functions performed, risks assumed and

assets used by each associated enterprise. The Profit Split Method may be applied on the basis of a contribution analysis or a residual analysis (see Chapter 3, paras. B.3.3.14.1 and following for further elaboration).

### Example 14

A Incorporated is engaged in providing internet and related services to the group’s customers worldwide. The services offered by A Incorporated include internet direct connec- tions, installations, configuration of routers and fully managed support solutions developed around the network services, with the aim that each member of the MNE can provide seamless network connectivity to customers across various locations and countries. The total circuit connectivity is also provided by the local licensed services provider. The MNE group operates in a number of countries and territories through successfully inte- grating several different networks into one and has consoli- dated its entities such that A Incorporated conducts business in most countries as a single multifunctional entity that provides a full range of solution services. In such a situation the profit split method can commonly be used as the most appropriate method for determining the arm’s length price of the interna- tional transactions, based on a residual profit analysis.

### Example 15

Air Express is engaged in the business of a logistics service provider offering a comprehensive portfolio of international, domestic and specified freight handling services. The group of entities is generally involved in international transactions involving freight services provided by associated enterprises. The business activities involve entering into contracts with third parties for moving their cargo from its source to desti- nations 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. All such activi- ties are carried out by associated enterprises in various coun- tries. The total expenses incurred in all countries are combined and then deducted from gross receipts and the residual amount

is shared in the ratio of 50:50 between the entity of the origin country and the entity of the destination country, based on a Profit Split Method.

### Example 16

An MNE group is operating in a few countries through its asso- ciated enterprises and providing agency services to various re-insurance companies and ceding companies, which place insurance risk by ceding it to re-insurance companies. Each entity in the group co-ordinates in giving technical guidance at the time of placement of the risk; handles premium collec- tions over the period of cover and the subsequent period; handles claims arising out of the proposals placed; receives the payment from the re-insurer and pays it to the re-insured persons. An entity in one country acts as a procurement broker of re-insurance proposals and a second entity in the second country acts as a placement broker. For successful placement the consolidated brokerage is paid by the re-insurer, and this is shared equally say on a 50:50 basis using another Profit Split Method. Each party bears its own expenses.

### Pass-through costs

* + - 1. In some circumstances an MNE group may decide to outsource some services to an independent entity and to use an associ- ated enterprise to act as an agent for the group to pay the accounts and to then allocate the charges to its associated enterprises on an objective basis. These may be called pass through costs. As an agent, its 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 to determine arm’s length pricing as a mark-up on the cost of the outsourced services rather on the costs of the agency function itself and allocate the outsourced costs without mark-up.

### Example 17

An MNE group 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 group has reviewed its oper- ations and has decided to keep in-house the activities in which it has a comparative advantage and to outsource activities that independent enterprises can provide at a lower cost. The MNE group has decided to outsource its human resources activities to an independent enterprise, Independent Company, in Country B for the whole group.

MNE Group 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 to group members on the basis of full time employee equivalents in the group. The charge is on a pass through basis as Subsidiary Company is not adding value and is merely used for conven- ience to distribute the human resource costs of outsourcing to Independent Company without a profit mark-up. In addi- tion, Subsidiary Company may provide a service in paying Independent Company and allocating the cost to group members.

### Allocation keys

* + - 1. The use of allocation keys provides 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 group, once the benefit test has been satisfied. An allocation key should be determined consistently for all associated enterprises concerned and should reasonably reflect each associ- ated enterprise’s share in the expected benefits from the intra-group services. An example of an inconsistent allocation key is one that uses different bases for allocating expenses for services to associated enter- prises in different tax jurisdictions.
      2. When selecting an allocation key, the taxpayer should consider 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 meas- ure of the respective benefit to each group 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 involv- ing a centralized advertisement campaign). In such cases, the alloca- tion 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).

* + - 1. 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 improve- ments in allocating expenses within an MNE group. Any allocation will benefit from having supporting evidence to justify that it allocates expenses within an MNE group on an appropriate basis. Determining whether an allocation key is appropriate requires an analysis of an MNE group’s facts and circumstances.
      2. 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 group; and
         * be documented.

Furthermore, care should be used where the allocation key is signifi- cantly affected by other intra-group transactions. For example, allocat- ing 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 percent- age of their sales to associated enterprises. This is because prices of the latter may be subject to adjustment under transfer pricing rules.

* + - 1. Examples of allocation keys include:
         * Sales;
         * Gross or net profit;
         * Units produced or sold;
         * Number of employees or full time equivalents (FTEs);
         * Salaries and wages;
         * Number of information technology users;
         * Office spaces or factor space;
         * Capital;
         * Operating expenses; and
         * The number of personal computers.
      2. The following non-exhaustive list contains allocation keys that are commonly used by MNEs for certain types of services:**62**
         * Information technology: number of personal computers;
         * 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: sales to independent customers; and
         * Vehicle fleet management: number of cars.
      3. These allocation keys are provided as examples and other allocation keys may be acceptable.

### Example 18

Manufacturing Co, Distributor Co and Personnel Co are asso- ciated enterprises in an MNE group. 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

62 See EU Commission, ‘Guidelines on low value-adding intra-group ser- vices’ (Brussels, 25.1.2011 COM(2011) 16 final), Annex I ‘List of intra-group services commonly provided that may or may not be within the scope of this paper’. There is no indication that these services are low value added services.

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% mark-up is 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 1000 employees and Distributor Co has 50 employees. These are 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 intra-group human resources services. The cost to be allocated per employee is ($500,000/1050) $476.19.

On this basis, the allocation key results in the following alloca- tion of the human resources service charge:

* Manufacturing Co: 1000 employees, $476,190.00
* Distributor Co: 50 employees, $23,809.50

## B .4 .5 . Safe harbours

* + - 1. It is often burdensome and costly to determine arm’s length prices if an associated enterprise provides a range of intra-group services. A practical alternative for a tax authority is to provide taxpay- ers 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 rates 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 addi- tion, safe harbours 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 concen- trate 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 available, this is to be preferred as it reduces the risk of double taxation.

* + - 1. 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 administra- tive 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 .** 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 cannot be expected to incur compli- ance costs to determine more precise arm’s length prices.**63**

### Low value-adding services safe harbour

* + - 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

63 These two safe harbours are based on the safe harbours in the Aus- tralian Taxation Office’s Taxation Ruling 1999/1 Income Tax: International transfer pricing for intra-group services, paras. 77– 87. Available from http:// law.ato.gov.au/atolaw/view.htm?Docid=TXR/TR19991/NAT/ATO/00001

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.

* + - 1. Low value-adding intra-group 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 cre- ating the profit-earning activities or contributing to economi- cally 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 sig- nificant risk by the service provider and do not give rise to the creation of significant risk for the service provider.
      2. The following services are common examples of low value-adding services:
         * human resources services;
         * accounting services;
         * tax compliance services; and
         * data processing.
      3. For an associated enterprise that is a distributor and marketer of an MNE group’s products, marketing services would fail to qualify as administrative services as they are directly connected to the enterprise’s main business activity.
      4. 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 group;
         * extraction and exploration services;
         * manufacturing services;
         * construction services;
         * financial services;
         * research and development services;
         * marketing and distribution services; and
         * strategic management services.
      5. 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 group.
      6. 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 gross profit margin is accepted in the other country; and
         * the documentation requirements.

### Example 19

Manufacturing Co, Distributor Co and Services Co are asso- ciated 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 econ- omies of scale and the relatively low labour costs in that coun- try. 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% 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 inbound and outbound intra-group services with a gross profit mark-up of 7.5%, and the total expenses claimed under the safe harbour cannot exceed 15% of the taxpayer’s total deduc- tions. 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 administrative services safe harbour.

On the facts, Distributor Co would be entitled to use the admin- istrative services safe harbour as the human resources are less than 15% of its total expenses and the mark-up on services is within the accepted range. On the basis that Distributor Co’s main business activity is distributing goods, human resources services would qualify as administrative services.

### Minor expense safe harbour

B.4.72. In the minor expense safe harbour option, a tax author- ity agrees to refrain from making a transfer pricing adjustment if the total cost of either receiving or providing intra-group services by an associated enterprise is below a fixed threshold based on cost and a fixed profit mark margin is used. 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 pric- ing rules would outweigh any revenue at stake. It also considers the potential administrative savings for a tax authority by avoiding trans- fer pricing examinations of minor expenses. An important require- ment is that the same fixed profit margin should be used for in-bound and out-bound intra-group services for a country. The safe harbour provides taxpayers and tax authorities with certainty. The minor safe harbour may contain the following requirements:

* a restriction on the relative value of the service expense (e.g. less than X% of total expenses of the associated enterprise receiving the services);
* a fixed profit margin;
* the requirement that the same profit margin is used in the other country, and
* the documentation requirements that are expected.
  + - 1. An example of a safe harbour for services is set out as follows.

For inbound intra-group services:

* + - * + the total cost of the services provided is less than X% of the total deductions of the associated enterprises in a jurisdiction for a tax year;
        + 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 intra-group services:

* + - * + the cost of providing the services is not more than X% of the tax- able income of the associated enterprise providing the services;
        + 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.

### Example 20

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. The total direct and indi- rect 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 that the services are low value-adding services. 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% of its total deductible expenses and thus below the 15% threshold. Accordingly, the maximum transfer price Subsidiary Co can deduct for the services rendered by Parent Co under the safe harbour option is $537,500. A transfer price up to this amount will be deductible by Subsidiary Co provided the documentation requirements are satisfied.

* + - 1. 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 cost plus margin is 5%, the service charge would have been $525,000. By using the safe harbour, Subsidiary Co has been able to claim $537,500 as a deductible expense in Country A for intra-group services without incurring the costs of a full transfer pricing analysis (which may have exceeded $12,500).

* + - 1. On the other hand, if the tax authorities in Country B are not aware of the safe harbour, they 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 at the level of Country A. To avoid this result, it is material that safe harbour requirements consider this possibility and a matching of income and costs is required.

### Example: list of low value-adding services developed by the EC

The following list of potential intra-group services is based on the list of intra-group services set out in Annex I ‘List of intra-group services commonly provided that may or may not be within the scope of this paper’ of the European Commission, ‘Guidelines on low value-adding intra-group services’ (Brussels, 25.1.2011 COM(2011) 16 final)**64**

* + - * + Information technology services:

building, development and management of the infor- mation system;

study, development, installation and periodic/extraor- dinary maintenance of software;

study, development, installation and periodic/extraor- dinary maintenance of hardware;

supply and transmission of data; and

back-up services.

* + - * + Human resource services:

h legislative, contractual, administrative, social security and fiscal activities connected to the ordinary and extraordinary management of personnel;

h selection and hiring of personnel;

64 Available from [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri) CELEX%3A52011DC0016

h assistance in defining career paths;

h assistance in defining compensations and benefit schemes (including stock option plans);

h definition of personnel evaluation processes;

h training of personnel;

h supply of staff for limited period; and

h coordination of the sharing of personnel on a temporary or permanent basis; and management of redundancies.

* + - * + Marketing services:

h study, development and coordination of the marketing activities;

h study, development and coordination of the sale promotions;

h study, development and coordination of the advertising campaigns;

h market research;

h development and management of Internet websites;

h publication of magazines handed out to clients of the sub- sidiary (even if concerning the whole group).

* + - * + Legal services:

h assistance in the drafting and reviewing of contracts and agreements;

h ongoing legal consultation;

h drafting and commissioning legal and tax opinions; h assistance in the fulfilment of legislative obligations; h assistance in the judicial litigation;

h centralized management of relationship with insurance companies and brokers;

h tax advice;

h transfer pricing studies; and

h protection of intangible property.

* + - * + Accounting and administration services:

h assistance in the preparation of the budget and operating plans; keeping of the mandatory books and accounts;

h assistance in the preparation of periodical financial state- ments, annual and extraordinary balance sheets or state- ments of account (different from the consolidated financial statement);

h assistance in compliance with fiscal obligations, such as filing tax returns, computing, and paying taxes, etc.; data processing;

h audit of the account of the subsidiary; and management of the invoicing process.

* + - * + Technical services, for example:

h assistance regarding plant, machinery, equipment, pro- cesses, etc.

h planning and executing ordinary and extraordinary main- tenance activities on premises and plant;

h planning and executing ordinary and extraordinary restruc- turing activities on premises and plant;

h transfer of technical know-how;

h providing guidelines for the products’ innovation;

h production planning to minimize excess capacity and meet demand efficiently;

h assistance in planning and implementing capital expenditure;

h efficiency monitoring; and

h engineering services.

* + - * + Quality control services:

h providing quality policies and standards of the production and provision of services;

h assistance in obtaining quality certifications; and

h development and implementation of client satisfac- tion programs.

* + - * + Other services:

h strategy and business development services in case there is a connection with an existing (or to be established) subsidiary;

h corporate security;

h research and development;

h real estate and facility management;

h logistic services;

h inventory management;

h advice on transport and distribution strategy;

h warehousing services;

h purchasing services and sourcing raw materials;

h cost reduction management;

h packaging services.

## B .5 . TRANSFER PRICING CONSIDERATIONS FOR INTANGIBLE PROPERTY

**B .5 .1 . Introduction**

* + - 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) revolu- tion 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 individ- ual businesses. It is therefore necessary to give careful consideration to intangibles when conducting a transfer pricing analysis.
      2. Transfer pricing issues can arise when MNEs develop, acquire, exploit or transfer intangibles. Various entities within an MNE group may participate in intangibles development through func- tions like research, development and marketing, providing funding for acquisition and development of intangibles, and exploiting intan- gibles in a wide range of business activities. These activities should be rewarded on an arm’s length basis. The business operations of one member of an MNE group may require the use of intangibles devel- oped or owned by other group members. Use by one member of the MNE group of intangibles belonging to or developed by other group members should be compensated on an arm’s length basis.
      3. Transfer pricing issues relating to intangibles should be resolved using the fundamental transfer pricing principles contained in Chapters B.1, B.2 and B.8 of this Manual. However, as intangibles may be unique, may be difficult to value and may be very important to the successful operation of the MNE group’s business, transfer pric- ing issues related to intangibles can be very challenging for both tax

administrations and taxpayers in developed and developing countries. This Chapter therefore supplements the general principles contained in earlier Chapters to provide special practical guidance on transfer pric- ing matters related to intangibles.

* + - 1. In carrying out a transfer pricing analysis involving intan- gibles it is necessary to consider: (i) the identification of the specific intangibles involved, (ii) the ownership of intangibles within the MNE group, (iii) the value of the identified intangibles, (iv) how the intangi- bles contribute to the creation of value by the MNE group, and (v) the identity of the members of the MNE group that contribute to intan- gible value and how they should be rewarded. This framework for analyzing transfer pricing issues related to intangibles is discussed in the following sections.

## B .5 .2 . Identifying Intangibles

### Definition of intangibles

* + - 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, whether that benefit derives from tangible property, intangi- bles, services or other activities. As is the case with other transfer pricing matters the analysis of cases involving the use or transfer of intangi- bles 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 trans- action 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 B.1,

B.2 and B.8 will apply in any event. The following definition is provided primarily to aid in discussion rather than to create a substantive differ- ence between cases involving intangibles and those that do not.

* + - 1. Difficulties can arise in a transfer pricing analysis as a result of definitions of the term intangibles that are either too narrow or too broad. If an overly narrow definition of the term intangible is applied

either taxpayers or governments may argue, incorrectly, that certain items fall outside the definition and may therefore be transferred or used without separate compensation, even though such use or transfer would give rise to compensation in transactions between independ- ent 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.

* + - 1. 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.**65** Whether something is recognized as an intangible for legal or account- ing purposes is an informative starting point but not determinative. It is not the case that all valuable intangibles are legally protected, regis- tered or recognized for accounting purposes.
      2. It is recognized that some countries use a different defini- tion in their domestic law. However, irrespective of whether an item is characterized as an intangible under domestic law, the transfer pric- ing analysis will be based on the definition above. Of course, other elements may need to be taken into account if they would affect pric- ing between unrelated parties. See for example the items discussed in section B.5.2.20. below.

### Common categories of intangibles

* + - 1. Notwithstanding the above, it is sometimes the case that labels, such as those described in paragraph B.5.2.7., are commonly applied to certain intangibles, often those with a legal status. While such categorization may be helpful in identifying intangibles as a starting point of the analysis, the approach contained in this chap- ter for determining arm’s length prices in 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

65 This definition is the same as the one in the G20/OECD Reports on BEPS Actions 8 to 10 released in October 2015.

or to prescribe outcomes that turn on such categories. The categories of intangibles described below are ones often considered in transfer pricing analyzes involving intangibles. They are illustrative and not intended to be comprehensive.

* + - 1. From a transfer pricing standpoint it should be empha- sized that generic references to the categorization as outlined below do not relieve taxpayers nor tax administrations from carrying out a thorough transfer pricing analysis in order to 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 does not apply differ- ently depending on the type of intangibles at stake.
      2. A common distinction is made between legally registered and non-registered 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 contractu- ally 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.
      3. 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 vari- ety 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.
      4. 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.
      5. 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.

* + - 1. In considering transfer pricing matters certain intangi- bles may sometimes be referred to as either (i) trade intangibles or (ii) marketing intangibles.
      2. 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.

### Marketing intangibles

* + - 1. Marketing intangibles may be created by marketing activ- ities, 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 sell- ing goods or services to customers.
      2. There can be a combination of central and local market- ing activities in MNE groups. In some cases the local marketing team performs marketing activities which are comparable to the activi- ties of comparable uncontrolled distributors. In other cases, the local marketing team carries out broader marketing activities than the ones of uncontrolled distributors, e.g. autonomously develops marketing campaigns or customizes the commercial offering beyond the guide- lines set centrally and accordingly, incurs significantly greater expenses than comparable uncontrolled distributors. In the latter case, the local marketing team may succeed in developing a marketing intangible.
      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).

* + - 1. 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,
         * 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 para. B.5.2.14. above.
      2. Depending on the facts and circumstances of the case, the broader marketing activities of the Distributor may give rise to differ- ing outcomes:

1. 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 compara- ble uncontrolled distributors;
2. The activities may lead to the creation of a local market- ing intangible (distinct from the foreign-owned brand) and attract a return greater than the one of otherwise compara- ble uncontrolled distributors, for instance if the resulting intangible is unique and valuable;
3. The activities may not lead to the creation of a local mar- keting 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;
4. The activities may not lead to the creation of a local mar- keting intangible but attract a return greater than the one of otherwise comparable uncontrolled distributors, for instance if the Distributor ‘s marketing activities are a valu- able contribution to the foreign-owned brand.

### Example 1:

Distributor X distributes branded products for which the brand is owned by a foreign affiliated enterprise. Assume that Distributor X has an innovative marketing team whose activi- ties 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 oper- ates. As a consequence, Distributor X is very successful in its market and its marketing expenses are significantly greater than the ones of otherwise comparable uncontrolled distribu- tors. Assume that the incremental marketing expenses are not reimbursed by the foreign brand owner.

In this case, the determination will likely be either solution b) or d) of the above list, i.e. Distributor X would attract a return greater than the return of otherwise comparable uncontrolled distributors.

### Example 2:

Distributor Y distributes branded products for which the 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 market- ing 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 solution a) or c) of the list at para. B.5.2.17., i.e. Distributor Y would not attract a return greater than the return of otherwise compara- ble uncontrolled distributors.

### Market features

* + - 1. The specific characteristics of a given market may affect the arm’s length conditions of a transaction between associated enter- prises in that specific market. In conducting a transfer pricing anal- ysis 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 Chapter 2, para. B.2.3.2.51. of the Manual.

### Goodwill

* + - 1. 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, a significant item often arising in discussions regarding the transfer pricing aspects of intangibles in the context of a business restructuring relates to the notion of goodwill.
      2. Depending on the context, the terms “goodwill” and “ongoing concern value” can be used to refer to a number of differ- ent concepts.
         * in some accounting and business valuation contexts, good- will 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 at para.

B.5.2.29. below);

* + - * + alternatively, goodwill is sometimes described as a represen- tation of the future economic benefits associated with busi- ness assets that are not individually identified and separately recognised;
        + 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 exist- ence 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 interrup- tion 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.
      1. It is generally recognised that goodwill and ongoing concern value cannot be segregated or transferred separately from other business assets.
      2. It is not necessary for purposes of this Chapter to establish a precise definition of goodwill or ongoing concern value for trans- fer pricing purposes or to define when goodwill or ongoing concern value may or may not constitute an intangible. It is important to recog- nise, 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 alter- native descriptions of goodwill or ongoing concern value.
      3. 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 admin- istrations to describe specifically relevant intangibles in connection with a transfer pricing analysis, and to consider whether independ- ent enterprises would provide compensation for such intangibles in comparable circumstances.
      4. 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 intangi- ble that reputational value should be taken into account in determin- ing appropriate compensation.
      5. If features of a business such as a reputation for produc- ing 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 characterised 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 characterised as good- will. In other words, all contributions of value should be compensated at arm’s length irrespective of how they are labelled.

### Purchase Price Allocation

* + - 1. 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 identi- fied 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).
      2. Goodwill under Purchase Price Allocation for finan- cial 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 exam- ple, to unaccounted synergies, other unaccounted sources of value or measurement errors) mechanically affects goodwill valuation as illus- trated below.

### Illustration of Purchase Point 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 intangi- ble 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 (if 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 (if valued as a bundle): 250

Trademark: 250

Unallocated “goodwill” 400

Total purchase price allocated: 1 000

### Example: MineCo

Assume MineCo owns a government license to carry out oil drilling activity in Ruritania as well another government license for the exploitation of the oil rig network existing within the country. The oil drilling license has a standalone market value of 70 as opposed to the oil rig license which has a market value of 30. MineCo does not own any other asset.

ExtraCo, an independent competitor of MineCo, acquires 100% of the equity interest in the latter company for a price of 150. In its PPA realized further to 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 aris- ing 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 market value 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, including procurement activities

* + - 1. Group synergies are not an intangible, but they can be significant in the analysis of the transfer pricing aspects of intangibles. Generally, because of the existence of an MNE group, the associated enterprises comprising such groups may benefit from the proactive or passive interactions amongst group members which are not accessible to comparable third party enterprises. This type of synergy does not constitute an intangible.
      2. Group synergies are particularly relevant to central procurement. For instance, group synergies arising as a result of combined purchasing power or the scalability of a certain activity, increased borrowing capacity due to being part of an MNE group, and so forth. To this end it is important to distinguish, on the one hand, between:
         * incidental benefits which are arising simply because of group affiliation; and
         * economic advantages arising due to the deliberate concerted action of one or more associated enterprises that are part of the MNE group resulting in what is normally labelled as “group synergy”.
      3. In the case under (i), an associated enterprise should not be deemed to have received an intra-group service, and should not be required to make an intra-group payment for such a service, simply because it has access to economic advantages by virtue of its group affiliation. In the case under (ii), however, there may be a clearly identi- fiable economic advantage due to the exact identification of the source

of the activities which have been put in place by one or more of the associated enterprises in the MNE Group and which can be quantified from a transfer pricing standpoint in the light of an accurate compara- bility (including functional) analysis at the level of each of the relevant associated enterprises.

B.5.2.31 In order to illustrate a simple central procurement func- tion, assume that the MNE Group N decides to implement a policy of cost savings. In this respect, it incorporates Company P in Country L to centralize the procurement function and take advantage of volume discounts that arise solely because of the MNE group’s aggregated purchasing. Assume that Company P does not take title of the raw materials from suppliers. The concerned group members directly acquire the raw materials from the suppliers under the conditions applying to the group. In this scenario, Company P performs a delib- erate concerted action which should generally be reflected in the pric- ing of a procurement fee to be paid by the group members to Company

P. The arm’s length consideration of Company P would typically be an administrative fee and should be less than the aggregated cost savings of the MNE group. This reflects the fact that in this scenario the most important driver in the discounts is the volume purchased by the group, not the services provided by Company P.

* + - 1. To illustrate a strategic, high value added procurement function, assume now that Company P recruits procurement special- ists with extensive experience in managing suppliers and cost cutting in the industry. Such procurement specialists build up expertise in the area of demand requirements for Group N, supply offerings and supplier contacts regarding Group N raw materials, industry supply chain strat- egies, etc. On the basis of their expertise they design the procurement strategy specifically for Group N based on demand, product specifica- tions and price; they carry out the vendor selection and contract negoti- ation; and they perform vendor evaluation and manage quality control functions. Company P therefore implements a deliberate concerted action of Group N which would warrant Company P receiving from other members of the group arm’s length remuneration that is appro- priate in view of the value created by Company P. Depending on the detailed facts such compensation may, but would not necessarily, include a share of the savings derived due to Company P’s actions. This reflects the fact that in this scenario, not only the volumes of purchases but also

the know-how deployed by Company P both contribute to the ability to obtain discounts. In this case the know-how of Company P is an intan- gible which warrants remuneration. The volume effect, however, is not an intangible and the benefit associated with that aspect should go to the individual group company or companies purchasing the products.

* + - 1. A further example illustrates a different scenario where title is customarily taken by a strategic, high value-added procurement function. Assume the fact pattern as in B.5.2.32., but assume addition- ally, that Company P takes title of the procured goods and through its personnel controls risks centrally regarding amongst others volume commitments, price fluctuations, exchange rate risks, quality control risks, etc. and has the financial capacity and capability to assume these risks. Company P resells the raw materials it purchases to other group members. In such cases, Company P would earn a profit margin on the products resold to the group members. Such profit margin should be appropriate in view of the value created by P, including the fact that it bears the working capital to fund inventory and reflect the range of risks associated with the procurement. Depending on the detailed facts, such profit margin may include a share of the anticipated savings derived due to Company P’s actions, and may be an amount that is greater at 5.2.32. This reflects the fact that in this scenario Company P is not only contributing value through its know-how but also through bearing inventory costs and associated risks.

### Workforce in place

* + - 1. Another important aspect to be taken into account in a transfer pricing analysis can be the existence of a qualified and skilled workforce.
      2. 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 intan- gible within the meaning of paragraph B.5.2.3. of this Chapter.
      3. Another situation concerns the transfer of an assem- bled 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 pric- ing method to be selected as well as the calculation of any potential indemnity has to take such elements into account.

* + - 1. From a transfer pricing standpoint it is important to distin- guish 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 group. As a general rule, it is very rare that a transfer of individual employees between members of an MNE group 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.
      2. 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 enter- prise to another.

### Example: Pricing algorithm

Assume that several employees of Company G have developed over the years a specific algorithm to accurately price deriva- tive instruments. The algorithm is owned by Company G since it was developed by the individuals in their capacity as employ- ees 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 consti- tute 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.

## B .5 .3 . Ownership of Intangibles and Transactions Involving Intangibles

### Analytical framework for the use or transfer of intangibles

* + - 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, using or contributing assets (including funding), and assuming risks.
      2. On the basis of the above, the guidance on the transfer pric- ing aspects of intangibles should be placed within the wider context of understanding the accurately delineated transaction including identi- fying, within the value chain, how associated enterprises make contri- butions in the form of functions performed, assets employed and risks assumed.
      3. The framework for analyzing transactions involving the use or transfer of intangibles between associated enterprises requires undertaking the following steps:

**Fact finding relating to *the intangible*:**

* + - * + identify the specific intangibles involved in the transaction between associated enterprises (see para. B.5.2 above);
        + identify the legal ownership of intangibles based on registra- tions, contracts and other relevant documents; (see paras B.5.3.7.–B.5.3.12. below); and
        + identify specific contributions made with respect to DAEMPE (development or acquisition, enhancement, maintenance, pro- tection and exploitation) of the intangibles involved (see paras B.5.3.13.–B.5.3.14. below).

### Fact finding relating to a transaction involving the *use or transfer* of intangibles:

* + - * + identify other contractual terms associated with the transac- tions (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 Chapter B.2 should be applied.

**Assess *consistency with the arm’s length principle of the remuner*ation of the transaction involving the use or transfer of intangibles between associated enterprises:**

* + - * + assess the consistency between the terms of the relevant con- tractual 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 actu- ally control and have the financial capacity to assume the risks;
        + based on the above, delineate the actual transaction between the associated enterprises involving the use or transfer of intan- gibles; and
        + determine arm’s length prices for the above-mentioned trans- actions consistent with each respective party’s contribution to the economic value generated from the intangible (unless the exceptional circumstances described in Chapter B.2, section

B.2.3.1.5 apply, such as, where the arrangements viewed in their totality are not commercially rational).

* + - 1. It is important to note that in the vast majority of cases involving an intra-group transfer of intangibles an arm’s length result will be achieved by pricing the accurately delineated transaction.
      2. 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 para. B.2.3.1.5. of the Manual.
      3. From a tax administration’s standpoint there are clearly risks in recharacterizing transactions in the context of intangibles. The latter solution indeed may create an increased risk of double taxa- tion, with no realistic prospect of cross-border relief in the event coun- tries 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 coun- try 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. See para. A.4.6. of the Manual.

### Legal Ownership and Contractual Terms

* + - 1. Legal rights associated with an intangible provide a start- ing point for the analysis. These may be found in registrations, contracts or other communications among 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.
      2. In the case of a licensed intangible there are two differ- ent intangibles, each having a different owner: the licensed intangi- ble 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.
      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 deci- sions concerning exploitation of the intangible and that has the practi- cal capacity to restrict others will be considered the legal owner.
      4. Legal ownership, by itself, does not confer any right ulti- mately 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 intangi- bles to be stripped away from entities which have developed or signif- icantly 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 exclu- sively remunerating only the legal owner.

* + - 1. Several types of returns are associated with an intan- gible, 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 assum- ing risk (this last return can be positive or negative, depending on whether and to what extent risks materialize).
      2. For instance, assume that the legal owner of an intangi- ble 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 enti- tled to share in any portion of the anticipated (ex-ante) return associ- ated with the development or acquisition, enhancement, maintenance, or commercial exploitation of the intangible, beyond the appropriate remuneration for its legal protection function.

### Example: RCo—R&D funding

Assume RCo is a member of an MNE group engaged in R&D activities, manufacturing and distribution of high tech widg- ets. 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 IP Company of the group. LCo then grants to RCo a licence for RCo to use the patents in manu- facturing 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 regis- ter the intangibles generated by the ongoing R&D functions performed by RCo.

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 associ- ated with the commercial exploitation of the asset, minus an arm’s length remuneration for the legal protection functions performed by LCo.

### The significance of Development, Acquisition, Enhancement, Maintenance, Protection and Exploitation of Intangibles

* + - 1. 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).
      2. 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 pharmaceu- tical company might commit to undertaking R&D in order to develop a potential blockbuster drug. This “D” reflects, in addition to the develop- ment functions (R&D), a commitment to contribution of assets to fund the development, and the assumption of potentially significant risks.

**Technical Note: “DAEMPE” and “DEMPE”**

By referring to “DAEMPE” in the U.N. 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 acqui- sition from a third party. See for instance para. 6.49 of the G20/OECD October 2015 Final Report on BEPS Actions 8-10.

### Functions, assets and risks contributing to DAEMPE

* + - 1. As discussed in B.5.3.13. accurately delineating the trans- action between associated enterprises involving the use or transfer of intangibles requires identifying which associated enterprises contrib- ute to DAEMPE. Such a process evaluates which entities perform func- tions, contribute assets and assume risks in the transactions involving intangibles.
      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 multina- tional 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.
      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 bene- fits, 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.
      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.

* + - 1. In respect of both acquired and internally developed intan- gibles, 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 paras B.5.3.28 and following for more details.
      2. 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 devel- opment of the intangible will be needed.

### 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 manufac- tured 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 trans- fer pricing analysis should imply that SCo has no claim in relation to the return derived from the exploitation of the intan- gibles associated with the trademark “MMD”, beyond an appro- priate remuneration for its invoicing activities.

### Risks

* + - 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.
      2. The guidance in Chapter B.2, 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 rele- vant 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 the expected costs of the required developments are and the possibility that such devel- opment 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 com- petitors will introduce products or services that would materi- ally 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 success- fully infringe the rights related to the intangible being devel- oped, 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 gener- ated by the intangible.
      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.
      4. Risk control and mitigation may be performed by vari- ous entities within the group. For example, assume that risk associ- ated 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.

* + - 1. Consistent with the guidance in Chapter B.2, if it is estab- lished that an associated enterprise contractually assuming the risk both controls and has the financial capacity to assume the risk asso- ciated 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 exercis- ing control and having the financial capacity to assume the risk.
      2. In this latter case, should multiple associated enterprises be identified that both exercise control and have the financial capac- ity to assume the risk, then the risk should be allocated to the asso- ciated enterprise or group of associated enterprises exercising most control. Other parties performing control activities should be remu- nerated 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 under- lying risk. Alternatively the contribution might be compensated in a manner that is not contingent on the underlying risk.

### Assets

* + - 1. According to the arm’s length principle, associated enter- prises contributing assets to the development or acquisition, enhance- ment, 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.

* + - 1. 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 poten- tial benefits of that R&D involves the risk that the R&D will be unsuc- cessful 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.
      2. 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 associ- ated 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 oppor- tunity and the decisions on whether and how to respond to the risks associated with the investment opportunity.

### “Ex ante” and “ex post” returns

* + - 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 applica- ble to intangibles, which are relevant to the difference between ex ante returns and ex post returns: time and risk, as discussed below.
      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 exam- ple if the R&D is not successful, then the company might suffer signif- icant losses.
      3. *Risk*: the difference between anticipated (ex ante) and actual (ex post) returns can arise from the materialisation of a vari- ety 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 actu- ally occurred. Who should bear the consequences of risk materialis- ing 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.
      4. The notion that all contributions to value must be appro- priately remunerated, as discussed above, is an ex ante concept.

### Example: 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 antici- pated (ex ante) return is 100, including 60 for AE’s R&D activ- ity, 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, 60 will still be for the contract R&D activity (through the cost plus service arrange- ment) 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.

### Return to funding and associated financial risk

* + - 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:

h one possibility is that the funder receives a share of the dif- ference between ex ante and ex post returns from the invest- ment. In this way, this type of investment is equivalent to an equity investment.

h another alternative is that the funder receives a pre-determined 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 trans- action, either type of investment could be consistent with the arm’s length principle.

* + - 1. 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.

### Example: TechCo Joint development

Assume that TechCo and High-Yield are members of an MNE group 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 develop- ment 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 intangi- ble, including the functions required to exercise control over the risk it has contractually assumed. Assume that the intan- gible development is expected to take seven years before being eventually successful for commercial exploitation purposes.

Under the contractual arrangement High-Yield Co will contrib- ute all the funding associated with the development of the intan- gible, 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 consol- idated 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 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% 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 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.

### Practical guidance for fact-finding in transactions involving intangibles

* + - 1. The fact-finding described in paragraph B.5.3.3. above is typically performed through a review of written documents, supple- mented 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 enti- ty’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 con- tractual risk allocation and the actual conduct of the parties** which may potentially impair the accurate delineation of the underlying economic transaction.

## B .5 .4 . Comparability

* + - 1. The general guidance in Chapter B.2 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;
        + the rights to 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 fea- tures, location savings, assembled workforce and MNE group synergies.

## B .5 .5 . Selection of the most appropriate transfer pricing method

* + - 1. The principles set out in Chapter B.3 of the Manual 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.
      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 para. B.5.6.8. 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 (cost plus, resale price or transactional net margin method) 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 that share in the risk of development (such as cost sharing or cost contribu- tion arrangements).
      1. A profit split method may be the most appropriate method if each party to a transaction makes valuable, unique contributions.

## B .5 .6 . Supplemental guidance for applying methods

### CUP method: acquisition price method in the case of transactions involving sales of intangibles

* + - 1. With regard to the application of the CUP method, some- times 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 intan- gibles. 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 repre- sent a useful starting point for determining the arm’s length price for the controlled transaction consisting of the transfer of intangi- bles 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.
      2. For instance, assume PenCo acquires for a price of 100 an 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 tangible assets is negligible.

* + - 1. Immediately following the acquisition, Z transfers all its rights in the developed and partially developed technologies, includ- ing patents, trade secrets and technical know-how, to “Y”, a subsidi- ary 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.
      2. 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 intan- gibles 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.
      3. In particular, given the above assumption that the price of 100 paid by PenCo represents the value of the technologies devel- oped 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.
      4. 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.

### Cost-based methods to value transfers of intangibles

* + - 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 costs of developing intangibles is seldom a reflec- tion 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 availa- ble 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 (includ- ing the value of the time needed to re-develop the intangible rather than acquiring it) may be used.

### Valuation techniques to value transfer of intangibles (“Discounted Cash Flow approach”)

* + - 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 particu- lar, 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 administra- tions as a part of one of the methods described in Chapter B.3 or as a tool that can be usefully applied in identifying an arm’s length price.

**Note on Discounted Cash Flow Methods**

The discussion of DCF methods in this Section is necessarily rudimentary in nature, as a fuller exposition of the theory and practical application of this method requires a separate volume. Corporate finance textbooks provide a fairly solid grounding in this area

* + - 1. Some transfers of intangibles involve risks associated with the uncertainty of future results. For example, an intangible trans- fer 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 don’t 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

* + - 1. 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 paras B.5.3.30. to B.5.3.35. for a discussion of ex ante versus ex post analyzes). That is, a DCF calculation is typically undertaken at the time of the initial intangible transfer, and prior to the actual reali- zation of income associated with the intangible. Since many audits are undertaken many years after the initial transfer, it is difficult to relia- bly apply a DCF method on an ex post basis. Accordingly, as a start- ing point it is important to determine if the taxpayer has undertaken at or prior to the intangible transfer an analysis of the anticipated prof- itability 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 profita- bility 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.

* + - 1. 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 the time of the transfer. See further para. B.5.6.26 below.
      2. Financial Projections: Financial projections**66** 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 possi- ble outcomes, as illustrated the example at para. B.5.6.14.
      3. 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 property is anticipated to occur. Exploitation of intangibles includes any direct or indirect use or transfer of the intan- gible property, 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).

66 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 meas- ures, appropriately applied.

* + - 1. 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% probability of sales achieving the expected outcome, a 25% prob- ability of sales achieving the optimistic outcome, and a 25% probabil- ity of sales achieving the pessimistic outcome. Assume further that production costs are estimated to be equal to 40% of sales and operat- ing expenses are estimated to be equal to 20% of sales. The taxpayer determines the most reliable financial projections by performing a probability-weighted calculation as follows:

Table B.5.1:

**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 B.5.2:

**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 B.5.3:

**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 B.5.4:

**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

* + - 1. 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 relia- bly 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 situa- tions, 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 example 5.1 turn out to be what was considered the optimistic scenario at the outset of the project, reflected in Table 2. From the ex post perspective of year 5 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 1, 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 1 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 develop- ment 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 lot- tery 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 an entirely different question is 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 para. B.5.6.26. As an illustration, if a person was ‘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

* + - 1. Where the purpose of the valuation technique is to isolate the projected cash flows associated with an intangible, it may be neces- sary 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 amortisation 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.

* + - 1. Applications of DCF approaches require the determi- nation 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 contrib- ute 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 valua- tion 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 neces- sary 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 exam- ple, 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 projec- tions 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% , 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 pres- sures, and other aspects reflecting the anticipated diminution of value over time of an intangible can be reflected in g, the growth factor. A nega- tive value of g, for example, can be used to reflect the expectation that competitive pressure will eventually and permanently reduce the antici- pated profitability of the intangible.

* + - 1. 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.
      2. Assume that the facts are the same as example at B.5.6.14. 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 activi- ties. 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% 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%. This is determined with reference to the weighted aver- age cost of capital of unrelated companies that engage in simi- larly risky projects.
      3. Under these assumptions, Company A would not surren- der 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 below:

**Table B .5 .5:**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **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 attrib- utable to intangibles | 53 | (100) | (100) | 115 | 115 | 115 |

* + - 1. The present value of operating income, discounted at an 11% rate, is 77. However, of that amount, the present value of the assumed arm’s length return to manufacturing and selling, under- taken 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 discount 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.
* Third, the financial projections are assumed to end at the end of year 5. Often financial projections extend beyond the years explic- itly documented through the use of tools such as terminal value calculations.
  + - 1. It is important to consider the assumptions and motivations that underlie particular applications of DCF approaches. For exam- ple, 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 trans- fer pricing purposes without a thorough examination of the underlying assumptions. In particular, valuations of intangibles contained in PPAs performed for accounting purposes are not determinative for transfer pricing purposes and should be used with caution and careful consider- ation of the underlying assumptions.

### Use of DCF methods by tax administrations

* + - 1. 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 infor- mation might be supplemented as part of a fact-finding exercise.
      2. As discussed in paragraph B.5.6.10., one of the character- istics making the application of a DCF analysis plausible in the first place is that the intangible is susceptible to reasonably direct finan- cial 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 profit- ability. It is important to note that there will inevitably be discrepan- cies 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 raise 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 example B.5.1)? What explains the divergence?
        + what is the company’s track record with respect to other rel- evant 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?; and
        + have there been unanticipated events subsequent to the initial transaction that wholly or partially explain the discrepancy?
      1. These questions may assist the tax administration in deter- mining 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 assess- ment 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.
      2. 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 administra- tion, ex post outcomes can provide a pointer to tax administrations as to the arm’s length nature 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 paras 6.186 – 6.195, and the discussion and conclusions of that Section are consid- ered valid in the context of this Manual.

### Other applications of DCF—using DCF to set ex ante contingent payments

* + - 1. A DCF can be used to determine on an ex ante basis an arm’s length contingent payment (e.g. royalty 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 applica- tion 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.
      2. Assume that the facts are the same as in example B.5.6.19. However, Company B agrees to compensate Company A on a contin- gent basis, based on sales. Based on the results in Table 5, a royalty rate of 36.9% on anticipated sales will result in a present value of 53 to Company A. That is, a royalty rate of 36.9% applied to anticipated sales of 312 in each of years 3, 4, and 5 yields 115 in each of years 3, 4, and 5. Taking into account the 100 in R&D costs undertaken by A in years 1 and 2, the present value of this income stream is 53. Accordingly, the arm’s length royalty rate is determined to be 36.9%, and this rate is applied to actual sales (which may differ from anticipated sales).

### Conclusion on valuation techniques

* + - 1. It is not the intention of this manual to set out a compre- hensive summary of the valuation techniques used by valuation profes- sionals. 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 valua- tion techniques are applied in a manner that gives due regard to 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

* + - 1. In some circumstances a transactional profit split method can be utilized to determine the arm’s length conditions for a trans- fer of intangibles or rights in intangibles. See para. B.3.3.13. at Chapter

B.3 of this Manual. In determining whether a transactional profit split method should be selected as the most appropriate to the transaction, the availability of reliable and sufficient data regarding combined prof- its 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.

* + - 1. Where a profit split method is found to be the most appro- priate method in a transaction involving the transfer of an intangi- ble or rights in an intangible, the following main questions need to be addressed:
         * what are the combined 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.
      2. Notwithstanding the above, the transfer pricing methods most likely to prove useful in transactions involving the use or trans- fer of one or more intangibles are the CUP and the transactional profit

split method. Valuation techniques can be useful tools to supplement the application of the above mentioned method.

* + - 1. Where information regarding reliable comparable uncon- trolled transactions cannot be identified, the arm’s length principle requires the use of another method to determine the price that uncon- trolled 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, loca- tion savings, assembled workforce and MNE group synergies.

## B .6 . COST CONTRIBUTION ARRANGEMENTS

**B .6 .1 . Introduction**

* + - 1. This chapter provides guidance on the use of cost contri- bution 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 group 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 intra-group 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.
      2. A CCA will satisfy the arm’s length principle if a partici- pant’s share of contributions to the CCA is in proportion to its share of expected benefits under the CCA.
      3. CCAs offer significant administrative advantages. As associated enterprises perform intra-group services for other group members and also benefit from intra-group services provided by other group members, a CCA can provide a mechanism for replacing a web of separate intra-group arm’s length payments with streamlined net payments based on aggregated benefits and aggregated costs asso- ciated 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 contribu- tions and risks, effectively achieving joint ownership of the resulting intangible.
      4. CCAs are used to develop future benefits such as tangible assets or intangibles, or to provide intra-group services. MNE groups 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 partic- ipants. Given the degree of risk involved, the sharing of costs and expected benefits may be a preferred approach. Moreover, a single asso- ciated enterprise may not have the resources or the capacity to individ- ually 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 coun- tries 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.
      5. Broadly, there are two distinct categories of CCAs: arrange- ments for sharing in the costs and benefits of intercompany services (service sharing arrangements), and arrangements established for the development, production, or obtaining of intangibles or tangible assets (development arrangements, most typically intangibles develop- ment 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 frame- work of sharing relative contributions in proportion to relative bene- fits, the motivation for these arrangements and some of the practical issues of implementing the arrangements may not be the same.
      6. In service sharing arrangements, for example, an MNE may decide to centralize its human resources operations or informa- tion technology (IT) function in an associated enterprise so the partic- ipants will share the costs of providing these services. The advantage of intra-group 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 group may decide to have its IT services provided by a participant in a lowcost 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.

* + - 1. Some of the savings from centralizing functions may arise from preventing unnecessary duplication of functions within an MNE group. 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.
      2. On the other hand, for example in an intangibles devel- opment 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 devel- opment, 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 intangibles.

## B .6 .2 . CCA features

* + - 1. The key characteristic of CCAs is that the participants agree to share the proportionate costs of creating or acquiring tangi- ble assets, creating or acquiring intangibles or providing services. They accordingly agree to have corresponding proportionate inter- ests 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 bene- fits of participating in CCAs varies. In some CCAs the benefits may be predictable at the outset but in other cases there may be uncer- tainty about the outcome. For example, it may be highly uncertain whether research and development will result in the creation of intan- gibles 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.
      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 group;
         * increasing operational effectiveness through shared activities and synergies within the MNE group;
         * the sharing of risks among the CCA participants; and
         * exploiting the knowledge of the participants through the shar- ing of know-how and best practices.
      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.
      4. The features of CCAs are:
         * having at least two participants;
         * a sharing of costs between the participants based on antici- pated benefits;
         * each participant should have a reasonable expectation of ben- efitting 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 con- sistent; and
         * arrangements exist for the departure of participants (“buy out”) from the CCA and the entry of new participants to the CCA (“buy in”).

## B .6 .3 . Participation in a CCA

* + - 1. Under the arm’s length principle, a participant in a CCA must expect to benefit from participating in the CCA. In particu- lar, the participant must have a specific interest in the tangible assets, intangibles or services of the CCA activity and must be capable of using the tangible assets, intangibles or services. The benefit that a CCA participant expects to receive is based on an objective predic- tion. Nevertheless, the decision is based on an expectation because of

the associated uncertainty and there is no requirement that the CCA benefits may be realized as CCAs often involve risk.

* + - 1. In some industries, the facts and circumstances indi- cate 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 often fail to result in patents and products which can be exploited commercially. Nevertheless, the phar- maceutical industry is competitive and MNE groups 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 develop- ment CCA may fail to actually provide benefits to the participants, this may simply reflect the playing out of risks, and is not in itself indica- tive that the CCA does not satisfy the arm’s length principle.
      2. The CCA activities may be carried out by one or more participants, or the activity may be undertaken by an associated enter- prise which is not a participant. If a non-participant associated enter- prise 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 tangi- ble assets. The consideration would be determined using a functional analysis and applying the appropriate transfer pricing methods in the Manual.

## B .6 .4 . Valuing CCA contributions

### General

* + - 1. To determine if a CCA satisfies the arm’s length princi- ple, it is necessary to determine the value of each participant’s contri- butions. 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 contri- butions and taking into account the mutual sharing of risks by the participants and the expected benefits that will be derived by the participants.
      2. Contributions to a CCA may take many forms. For service sharing arrangements, contributions primarily consist of the perfor- mance 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.
      3. There is a difference between current contributions and pre-existing contributions. Examples of pre-existing contribu- tions would include the contribution of patented technology with pre-existing value that is useful towards the development of the intan- gible which is the subject of the CCA, or the contribution of a tangi- ble 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 at Chapter B.5.
      4. Current contributions, on the other hand, are ongo- ing contributions that should be valued at market value. An exam- ple 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. The current value of contributions should be determined in accordance with the arm’s length principle in this Manual.
      5. Although under the arm’s length principle all contributions should be measured at value, it may be easier for participants to meas- ure current contributions at cost. If this approach is adopted, the value attributed to the pre-existing contributions should recover the oppor- tunity 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 develop- ment 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 work- force and the value of the intangible contributions).
      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 insig- nificant. 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.

B.6.4,7. In some situations budgeted costs may be used for valu- ing 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 differ- ences 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.

* + - 1. As stated above, all contributions by participants to a CCA must be recognized. Contributions to be considered include contribu- tions used exclusively for the CCA and also contributions used partly in the CCA and partly in the participant’s business activities. The apportionment of valuation of contributions may be difficult in some situations. A participant may contribute the use of its business prem- ises including tangible assets such as plant and equipment, and the participant may also provide certain services to the CCA. The partic- ipant 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 busi- ness premises and the use of plant and equipment. The apportion- ment of contributions for valuation purposes should be based on the facts and circumstances and accepted accounting principles. If mate- rial 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.

### Treatment of government subsidies

* + - 1. 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 develop- ment CCA. The alternative approaches are to value the participant’s contribution and disregard the subsidy or to value the contribu- tion 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.

## B .6 .5 . Predicting expected benefits

* + - 1. For an associated enterprise to participate in a CCA it must have an expected and identifiable benefit. An associated enter- prise’s expected benefit is important in determining the enterprise’s contribution and whether the allocation method (e.g. allocation key) used by the MNE group is acceptable for the tangible assets, intangi- bles 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 main- taining its commercial and financial position. For intra-group services one of the main advantages which would be expected from the central- ized 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.

* + - 1. “Allocation keys” are often used by MNEs as an indirect method to approximate the respective future benefits of each partici- pant 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 bene- fits; the factors to be used must be determined on the facts and circum- stances of the CCA.
      2. 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 contri- butions during the course of the CCA on a prospective basis to reflect changes in the ratio of the expected benefits of the participants.
      3. 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 signifi- cant. Accordingly, it can be difficult to measure the expected bene- fits flowing from research and development CCAs. Discounted income or cash flow methods are often used (See paras B.5.6.8. and follow- ing of Chapter B.5). Under the arm’s length principle, a partici- pant’s contributions to a CCA must be consistent with its share of the expected benefits. This requires a direct approximation of a partici- pant’s expected benefits and ensuring that its contributions reflect its 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.

### Example: Development of new technology

Assume that Company A and Company B enter into a CCA in Year 1 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 6 Company A will receive 75% of the benefits and Company B will receive 25% of the benefits. Total development costs are 100 each year.

In years 1, 2 and 3, Company A pays 75 in CCA related costs and Company B pays 25 in CCA related costs. At the end of Year 3, 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 4 and thereafter that Company A will derive 50% of the total benefits and Company B will also derive 50% of the projected benefits over the useful life of the technol- ogy 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% and 50% of the costs incurred in Years 1, 2 and 3). This balancing payment should be made in Year 4. Also in Year 4 and Year 5, 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% of the CCA development costs and each would anticipate receiving 50% of the benefits of exploiting the new technology, as follows:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Year 1** | **Year 2** | **Year 3** | **Balancing Payment Year 4** | **Year 4** | **Year 5** | **Total** |
| 75 | 75 | 75 | (75) | 50 | 50 | 250 |
| 25 | 25 | 25 | 75 | 50 | 50 | 250 |

## B .6 .6 . Non-arm’s length CCAs

* + - 1. A CCA will fail the arm’s length test if the participant’s contributions are inconsistent with their share of the expected or real- ized 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 circumstance 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.

### Balancing payments

* + - 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 is excessive and correspondingly, the contribu- tions of at least one other participant will be inadequate. In this situa- tion, under the arm’s length principle a balancing payment is required by the participants whose contributions are inadequate. The balanc- ing payment will increase the value of contributions of the payer and decrease the value of contributions by the payee.
      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.
      3. Balancing payments may also be required by tax author- ities. A tax authority may make an adjustment to remedy an identi- fied 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.
      4. When such deficiencies are identified they may be reme- died by a balancing payment. A tax authority examining a CCA and concluding that an adjustment is required may treat a partic- ipant 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 adminis- trations 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 partici- pant’s share of the projected benefits over the useful life of the tangible assets and intangibles developed under the CCA.

### Disregarding the CCA terms

* + - 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, paragraphs B.2.3.1.4. -

B.2.3.1.9. are relevant as to the ability of tax authorities to disregard CCA arrangements in limited circumstances.

* + - 1. 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 author- ity may conclude that the arrangement fails to comply with the arm’s length principle (since an independent enterprise would not partici- pate in such an arrangement) and it may thus disregard the CCA.

## B .6 .7 . CCA entry, withdrawal and termination

* + - 1. At the time when a CCA is established, one or more partic- ipants 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 partic- ipant may be required to make a payment in return for acquiring an interest in the benefits that have been created under the CCA. A partic- ipant 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.

### “Buy-in” payments

* + - 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.
      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 inter- est 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 prin- ciple and a balancing payment made to make up differences if the buy-in payment required is greater than the value of the items being contrib- uted by the new participant. Alternatively, if the value of the intangi- bles 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.
      3. The treatment of a buy-in payment for tax purposes should be determined under the domestic law and tax treaties of the partic- ipants’ countries. The payment should be treated as a payment to an independent enterprise to acquire an interest in intangibles, rights and work-in-progress.

### “Buy-out” amounts

* + - 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. 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 treat- ment 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 enter- prise to acquire an interest in intangibles, rights and work-in-progress.

* + - 1. 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.

### Termination of a CCA

* + - 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 surren- ders 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.

## B .6 .8 . General CCA Requirements

* + - 1. CCAs should list the participants and their respective inter- ests 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 tangi- ble 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.
      2. In general, CCAs between associated enterprises should meet the following requirements:**67**

67 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, para. 8.50.

* + - * + 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 these (i.e. the OECD) Guidelines and, where necessary, balancing payments should be made to ensure the proportionate shares of contributions align with the propor- tionate 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 par- ticipants; and
        + adjustments would be made as necessary (including the pos- sibility of buy-in and buy-out payments) upon the entrance or withdrawal of a participant and upon termination of the CCA.

### Documentation

* + - 1. Participants in a CCA are required to prepare documenta- tion on the nature of the CCA, the terms of the CCA, and the expected benefits and compliance with the arm’s length principle. The docu- mentation should include information on:**68**
         * 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;

68 Ibid., para. 8.52.

* + - * + 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.
      1. In addition, the OECD Transfer Pricing Guidelines encourage participants 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.

### 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 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 1 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:

1800 + 1050 = 2850 (50% of total value of 5700) Benefit to Company B:

1800 + 1050 = 2850 (50% of total value of 5700)

**Contributions measured at value:** Under the CCA, Company A should bear the costs associated with 50% of the total value of contributions (5700), or 2850. The market value of Company A’s in-kind contribution is 3600. Company B should bear the costs associated with 50% of the total value of contributions, or 2850. The value of Company B’s in-kind contribution is 2100. Accordingly, Company B should make a balancing payment to Company A of 750.

### Example: EU report on differences between CCAs and service arrangements

It is difficult to distinguish between a CCA and intra-group services allocated through an allocation key. The following differences between CCAs and services arrangements within an MNE group have been identified:**69**

|  |  |
| --- | --- |
| **CCAs** | **Intra-group service arrangements** |
| A CCA is an agreement to share costs, risks and benefits where the participants contribute cash, prop- erty or services. | Intra-group services are limited to the provision and acquisition of spe- cific services within an MNE group. |
| The service provider and the recipi- ents are all party to the one CCA. | The associated enterprise providing the services may enter into a sepa- rate agreement with each associated enterprise. This may result in the service provider having numerous bilateral agreements for the provi- sion of intra-group services. |
| If a participant joins or leaves a CCA, a corresponding adjustment is required to be made on the contri- butions and the entitlements of each associated enterprise. | If an associated enterprise decides to expand a service arrangement or terminate the service arrange-  ment, there is no effect on the other associated enterprises receiving the  services. |
| A detailed written agreement con- taining the information set out at para.B.6.45. | In some cases, written contracts may not be prepared. |
| The contributions of the partici- pants are measured on a contribu- tion 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. |

69 EU Joint Transfer Pricing Forum, Report on Cost Contribution Arrangements on Services not creating Intangible Property, (2012) (JTPF/008/ FINAL/2012/EN), para. 12. Available from <http://ec.europa.eu/taxation_cus-> toms/sites/taxation/files/resources/documents/taxation/company\_tax/trans- fer\_pricing/forum/jtpf/2012/jtpf\_cca\_report\_en.pdf

|  |  |
| --- | --- |
| **CCAs** | **Intra-group service arrangements** |
| The allocation of costs under the arm's length principle must be based on each participant's expected ben- efits under the CCA. | The allocation key is designed as a proxy measure of the expected benefits that the recipient associ-  ated enterprise will receive from the  services. |

## B .7 . TRANSFER PRICING ASPECTS OF BUSINESS RESTRUCTURINGS

**B .7 .1 . Setting the framework and definition issues**

### General

* + - 1. In recent years the tax aspects of business restructurings undertaken by multinational enterprises (MNEs) have attracted much attention from tax authorities all around the globe. From a transfer pricing standpoint such reorganizations require consideration of how to apply the arm´s length principle to a sound cross-border redeploy- ment of functions, assets and risks within the same group.
      2. There is no legal or universally accepted definition of “business restructurings”. In a transfer pricing scenario these transac- tions 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 need not be confused with the ordinary acquisition of a busi- ness or an ongoing concern. However, it may be common to proceed with a business restructuring of the supply chain operations of an MNE group following an acquisition, divestiture of a business, or in response to the changing business environment.
      3. Common examples of business restructurings are reorgan- izations involving conversions of the manufacturing and/or distribu- tion layer of an MNE such as (i) conversion of a buy-sell distributor into a commissionaire or (ii) conversion of a fully-fledged manufacturer into a provider of manufacturing services. Business restructurings may also involve the transfer of the ownership and management of intangible property rights such as patents, trademarks, brand names etc.
      4. As a general rule businesses are entitled to organize their activities in the way they see fit. Business restructuring undertaken in

a manner consistent with the arm’s length principle is entirely appro- priate. However, there may be situations in which business restructur- ings 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 restructur- ings to ensure that they are consistent with the arm’s length principle.

* + - 1. The application of Article 9 of the United Nations 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 trans- fer of something of value, or for the termination or substantial renegoti- ation of commercial arrangements between associated enterprises, and if so what the amounts of such arm’s length consideration would be.

### Business Restructurings: Considerations regarding Developing Countries

* + - 1. The changes triggered by the implementation of a busi- ness restructuring can have significant effects on the allocation of profits (or losses) between the countries in which the entities operate, regardless of whether or not tax savings are a driver. When a multi- national group changes its business model, the tax and legal structure of the group would generally require an alignment with the new busi- ness model.
      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 labor of a skilled workforce is lower and/or (ii) simi- larly moved certain distribution functions and/or (iii) similarly moved valuable intangible property out of the jurisdiction where they were acquired, developed or exploited. This Chapter discusses how to deter- mine, on a case by case basis, whether or not the conditions of such restructurings comply with the arm’s length principle.
      3. In a business restructuring context, the arm’s length prin- ciple 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 considera- tion 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.

* + - 1. 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.
      2. The above mentioned process with respect to the imple- mentation of the arm’s length principle highlights the need for author- ities 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.

### Process for setting or testing the arm’s length principle in business restructuring operations

* + - 1. This paragraph 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
      2. As a first step, it is important to characterize the transac- tions entered into by the associated enterprises, taking into account the business environment in which the MNE group 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 contract, including those entered into to implement the business restructuring (e.g. contracts transferring the legal ownership of certain intangible property 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 enter- prises; 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, eco- nomic 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 per- formance of a thorough functional analysis, which is needed to identify the value-adding activities and functions performed, assets used and risk assumed in respect of the business activi- ties affected by the restructuring.
      3. The selection of the most appropriate method or meth- odologies applicable to the transaction(s) at stake follows from the functional analysis. As discussed in more detail below, a business restructuring is commonly implemented through a series of inter- twined transactions. For instance, a business restructuring might involve transferring functions, assets and risks to a tax favorable loca- tion. This should not of itself warrant the conclusion that a non-arm’s length arrangement has been implemented.
      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 require- ments are met.
      5. For example, an associated enterprise may transfer the ownership of an intangible asset to its foreign principal and also agree to enter into a licensing agreement with that company. In determin- ing 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.
      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 exist- ing within MNE groups. However, the lack of reliable third party data should not lead the tax authorities to automatically conclude that the business restructuring as a whole is not respecting the arm’s length prin- ciple. Where such reliable uncontrolled comparable data are lacking, the consideration that might reasonably be expected in similar circum- stances 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 pro- tect its economic interest involved in the arrangements, or be appropriately remunerated for foregoing such interest;
         * an independent party dealing at arm’s length would compare the options realistically available in a comparable transaction and seek to leverage the overall value derived from the eco- nomic resources at its disposal. In certain cases, one realisti- cally available option might be not to enter into a transaction in the event that it does not make commercial sense.
      7. A key feature in understanding the underlying commer- cial 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. To this end, a business restructuring may be triggered as a response to changes in the business environment in which the asso- ciated enterprise involved is running its activities, such as competitive

pressures, market conditions or changes in the regulatory environ- ment. In the light of such changes an MNE operating at arm’s length 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 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.

* + - 1. 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 commer- cial advantages to the enterprise are expected from contracting, as compared with performing the activity by itself. These expected commercial advantages may relate to cost reduction and/or retaining or increasing profits.
      2. When restructuring, an MNE may undertake a cost-benefit analysis. Should such an analysis exist and be documented it may be helpful (as well as any other financial and commercial data relevant to the restructuring) to determine the existence of the underlying commercial rationale triggering the restructuring.
      3. An MNE group may fragment functions across several group companies to achieve efficiencies by exerting group management coordination functions. For instance, it is nowadays quite common in restructuring the supply chain of highly integrated MNE groups to allocate into different legal entities functions such as logistics, ware- housing, marketing and sales. As the functions represent generally the core of the supply chain of an MNE group this may require coordina- tion of activities at the group management level in order for the sepa- rate activities to interact effectively.
      4. Accordingly, when conducting a functional and risk anal- ysis of the controlled transactions between the associated enterprises carrying out the fragmented activities, the economic benefits to the MNE group expected from the activities conducted separately should be identified within the context of the broader arrangements.

## B .7 .2 . Types of business restructurings

* + - 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 or commissionaires (or vice versa); and
         * as regards the **management of valuable, unique intellectual property rights**, the transfer of either trade or marketing intan- gibles to foreign Intellectual property holding companies.
      2. As a result, the restructured entity may end up perform- ing limited routine functions, holding minimal assets, bearing low 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.
      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.
      4. Taxpayers are generally free to arrange their business oper- ations as they see fit but tax authorities have the right to verify consist- ency 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, para. B.2.3.1.4. and following in Chapter B.2 of this Manual for a discussion of the recognition of the actual transaction.
      5. Although a country may not have specific transfer pric- ing provisions dealing with cross border restructurings, transactions

entered into with the sole purpose of obtaining an undue tax saving could eventually be challenged either by the application of a general or a specific anti-avoidance rule (if present in the tax system of the juris- diction concerned).

* + - 1. 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 disre- garded. 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.

### Transfer of functions and risks arising from business restructurings

* + - 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.
      2. To this end the following situations can be envisaged:
         * 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 B.5 on intangibles in this respect; and
         * further, or alternatively, it may fall 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 arrange- ments so as to identify the content of any termination clause, and (ii) the determination of whether a third party would war- rant an indemnification in the event of a comparable termina- tion or substantial renegotiation of contractual arrangements.
      3. Some taxpayers have entered into business restructur- ings 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 justi- fying the premium returns. It will be relevant to determine whether

the principal has the capability to and actually controls the econom- ically 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 B.2 of this Manual, particularly at para. B.2.3.2.23. and following.

* + - 1. For example, assume that Company A was a fully-fledged manufacturer of widgets which, among others, assumed econom- ically significant inventory risk. Further to a business restructur- ing, Company B is set up as a principal. Under the new contractual arrangements between Company A and Company B the latter is obliged to produce widgets according to the quality standards and production plan provided for by Company A. The contractual arrange- ments indicate that Company B is responsible for the inventory risk. From a factual analysis, it is proven that Company B does not have any control over the inventory risk, i.e. it does not exert any decision making power in relation to the production plan and has no influ- ence over the deployment of risk mitigation strategies if the inventory quantity rises because of a sales slow-down. In such a situation the risk and associated consequences should be re-allocated to Company A, i.e. the company actually controlling and managing the risk.

### Termination or substantial renegotiation of existing arrangements

* + - 1. In the case of a contract termination or substantial rene- gotiation, 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 indem- nification may, for instance, encompass the loss of future expected profitability. There is a wide variety of elements that may be taken into account by commercial judges in determining whether a termination period indemnification should be applied, for instance the nature and terms of the contractual arrangements and/or the economic depend- ence of one party on another.
      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 deter- mined whether such terms and conditions are arm’s length.

* + - 1. 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 appears specifically relevant in the context of a cross-border business restruc- turing, 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.

### Example: Operational Considerations on the Transfer Pricing Aspects of a Business Restructuring

* + - 1. The following example illustrates the application of the approach to business restructurings as outlined above. The exam- ple summarises the indicative issues which might arise in addressing the application of the arm’s length principle to any specific business restructuring arrangement.
      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 owns or holds licensing rights over all the intangibles (such as patents, trademarks, and a legally protected specific “Just-in-Time” manufacturing planning know-how) 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 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.
      1. As far as financial results are concerned, OpCo has recorded relatively strong and stable profits over most of the last 10 years, although they have been gradually declining over the last 3 (three) years due to adverse global economic market conditions which triggered a steep increase of the input costs of production. The finan- cial outlook for the next five years forecasts a continued decrease of profitability due to increased competition.
      2. In the year 2000+X, the MNE of which OpCo is a member decides to enter into a restructuring of the supply chain manufactur- ing layer, by centralising its management and control activities in a regional headquarters located in Country B and operated by the asso- ciated enterprise, Principal Co. The MNE’s top management high- lights during the shareholder meeting that the underlying commercial rationale for entering into the restructuring is to achieve forecasted costs savings and efficiency gains allowing the group to achieve sustained profit growth over the following 5 (five) financial years.
      3. In particular, the implementation of the business restruc- turing arrangements requires the implementation of the following steps:
         * OpCo transfers to Principal Co by means of an outright sale arrangement all the intangibles 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 agree- ments 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 procure- ment 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 control of 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 ser- vices provided by OpCo. The fee is calculated by adding a mark-up of 10% over the costs incurred by OpCo. Moreover, 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 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 distrib- utors are terminated as part of an arrangement with Principal Co, whereby the latter company will enter into identical agree- ments 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 manufac- turing function).
      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 C.2) 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?; and
         * Does the functional analysis 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 contrac- tual arrangements?
      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 select the most appropriate transfer pricing method in the circumstances of the case. See Chapter B.3 on the selection of the most appropri- ate method.
      3. Relevant comparable data in the above example may include: (i) similar uncontrolled arrangements involving a business restructuring with the conversion of an entity in a toll manufacturer;

1. similar uncontrolled transfer/sales agreements of patents and trademark rights; (iii) the terms governing the termination of uncon- trolled 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.
   * + 1. Depending upon the extent of such comparable data, any other available information relevant to determining whether the busi- ness 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 them at arm’s length.
       2. If reliable comparables cannot be identified, the tax authorities may still achieve an arm’s length outcome by hypothesising the conditions that might reasonably be expected to be agreed upon between independent enterprises dealing at arm’s length in compara- ble circumstances.
       3. Most notably, an important question to be addressed entails whether any compensation should be expected between OpCo and Principal Co had a similar agreement been entered into by independent enterprises dealing at arm’s length in comparable circumstances.
       4. 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) 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.

* + - 1. 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 (e.g. for the “Just-in-Time” manu- facturing know-how) and distribution agreements, which resulted in a substantial renegotiation of its manufacturing status.
      2. Thirdly, as an independent party, would OpCo realisti- cally have the option of continuing these arrangements? In particular, given all the legal, commercial, economic and financial circumstances, would OpCo as an independent party have any option realistically available to it 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.
      3. Would Principal Co as an independent party have any option realistically available to it other than to enter into the busi- ness restructuring on the agreed terms? Would Principal Co have the option of entering into similar licensing, distribution and toll manu- facturing arrangements without involving OpCo?
      4. Moreover, does Principal Co have both the decision-making capability and financial strength to assume and manage the risks trans- ferred to it by OpCo? Does Principal Co have the decision-making capability and financial strength to assume and manage the risks associated with the ownership of the patents, trademarks and “Just-in- Time” manufacturing know-how?
      5. Should the examination of the case conclude that the pric- ing of the business restructuring makes commercial sense for the parties, based on the information available to the taxpayer at the time the restructuring was entered into and having regard to their economic circumstances and the options realistically available to them at arm’s length, this would determine the amount of the arm’s length remuner- ation receivable or payable by OpCo under the arrangement.
      6. Should the examination of the case conclude that the pric- ing of the business restructuring did not make commercial sense for the parties based on the information available to the taxpayer at the time the restructuring was entered into, then the tax administration should seek to achieve an arm’s length outcome primarily by a pricing adjustment (for example, by computing upwards the taxable profits of OpCo or by adjusting any agreed amount of compensation receivable or payable by OpCo) by reference to the arrangement as entered into by the associated enterprises.

## B .8 . GENERAL LEGAL ENVIRONMENT

**B .8 .1 . Introduction**

* + - 1. Transfer pricing rules were introduced in domestic legis- lation by the United Kingdom in 1915 and by the United States in 1917. Transfer pricing was not an issue of great concern, however, until the late 1960s when international commercial transactions expanded greatly in volume. The development of transfer pricing legislation was historically led by developed countries; in recent years, however, with the growth and complexity of international “transfers” within MNEs, both developed and developing countries are introducing legislation to address transfer pricing issues. See Chapter B.1., para. B.1.3. for more on the evolution of transfer pricing rules.
      2. Domestic transfer pricing legislation worldwide shows some harmonisation in basic principles, in accordance with the arm’s length standard, even if the application is not identical across jurisdic- tions. The introduction of transfer pricing rules has taken place within different legislative traditions, and in the context of the sovereign right of countries to address taxation matters. The reasons why there has been a great deal of consistency in approach include:
         * The broad acceptance of the arm’s length principle as the best current alternative for dealing with transfer pricing issues;
         * Many countries have adopted the UN or OECD forms of Article 9 in their bilateral tax treaties, and have therefore already committed to it; and
         * The benefits of similar approaches between countries in terms of avoiding double taxation or double non-taxation.
      3. With the increase in cases where tax authorities have made adjustments to transfer prices set by related entities, taxpayers increas- ingly seek practical dispute resolution mechanisms to avoid double taxation. As a result, mutual agreement procedure (MAP) discussions

as set out in bilateral treaties**70** have been made more effective through supplementary domestic regulations, as well as practice regarding the conduct of the MAP.

* + - 1. Many countries have implemented advance pricing agree- ments (APAs) in their legal or administrative procedures as a bilateral 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 solutions are dealt with in Chapter C.4.; however, the application of these solu- tions will be influenced by the legal environment of each country, and thus will take place in a variety of ways.
      2. 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. New legislation has to be appropriate to the needs of a particular developing country. This means that any legisla- tion 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, including ease of practical administration of and compliance with the rules it contains. Those reasons and the “environ- ment” of the legislation should be compared with those in the country developing transfer pricing rules. This analysis will help indicate what adaptation, if any, of the legislation is needed for it to work effectively in the conditions of a particular country.
      3. It is important that drafters of transfer pricing legisla- tion take into account the outcomes of the BEPS Project, especially regarding Actions 8, 9, 10 and 13 (8 — Intangibles; 9 — Risks and capi- tal; 10 — Other high-risk transactions, and 13 — Transfer pricing documentation).**71** These issues tend to have a more harmonized legal approach in a post-BEPS Project era.

70 Based upon Article 25 of both the UN and OECD Model Conventions.

71 Reports available at <http://www.oecd.org/tax/beps/beps-actions.htm>

## B .8 .2 . Domestic Transfer Pricing Legislation: Structural Overview

* + - 1. As already noted in Chapter B.1 “transfer pricing” is essentially a neutral concept. However, the term is sometimes used, incorrectly and in a pejorative sense, to mean the shifting of taxa- ble income from one company within an MNE, located in a high-tax jurisdiction, to another company of the same group, in a low-tax juris- diction, through incorrect transfer prices. The aim of such practices is to reduce the overall tax burden of the group. This involves a trans- fer price, but is more accurately referred to in this Manual as a type of transfer mis-pricing; the issue is not that there has been a “transfer price” set (as there must be in such a transaction, however legitimate) but that the price set is not an arm’s length price. See Chapter B.1., at para. B.1.1.7., for examples.
      2. Many countries have introduced specific domestic tax rules to prevent possible tax base erosion through mis-pricing of transactions between related parties. As noted above, this legislation is almost invariably proposed as being 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 (group companies) but also among cross-border units of a single entity. Under the arm’s length principle, it is in principle necessary to conduct a comparability analysis of third party transactions. However, when the taxpayer fails to provide the tax authorities with the required data to compute an arm’s length price in particular circumstances some countries have adopted a presumptive taxation method (discussed at para. B.8.7. below). This is normally subject to rebuttal by a taxpayer, who may present counter-evidence to show the results as being at arm’s length.
      3. Another approach to transfer pricing income allocation is referred to as global formulary apportionment (GFA), see Chapter B.1., para. B.1.4.14. for further information. However, such a system cannot operate at a global level, in a way that fully avoids double taxation, without prior agreement on a suitable uniform formula, which is yet to be achieved. Before joining the OECD, the Republic of Korea used to apply the GFA method on the grounds that this method provided more certainty and also reduced compliance costs for taxpayers. However,

around the mid-1990s, the tax authorities of the Republic of Korea revoked some of their own guidelines based upon GFA acknowledging that GFA is not consistent with the arm’s length principle. This Manual addresses transfer pricing rules based on the arm’s length principle; developing countries almost invariably accept the arm’s length princi- ple as the basis of their bilateral tax treaty provisions on related party dealings and in their domestic legislation addressing the same issues. This Manual does not deal with the advantages and disadvantages in the longer term of any possible alternative ways of dealing with trans- fer pricing, including GFA.

* + - 1. Two different broad approaches may be seen in domestic legislation relating to transfer pricing. Both of these seek to implement an arm’s length approach in relation to controlled transactions:
      2. The first possible legislative approach simply author- izes the tax administration to distribute, apportion or allocate gross income, deductions, credits etc. when they determine that such distri- bution, apportionment, or allocation is necessary in order to prevent tax avoidance or clearly reflect the income of any organizations, trades, or businesses.**72** Under this system there is no reference to the taxpay- er’s compliance obligation in determining the arm’s length principle, while the arm’s length principle may be stipulated in either the general legislative principle or within regulations or secondary legislation supporting the primary legislation.
      3. The second legislative approach stipulates that, based on the self-assessment system, any foreign affiliated transaction shall be deemed to have been conducted on an arm’s length basis for tax purposes if that transaction is not in fact conducted at arm’s length.**73** 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.
      4. A country’s choice between the two above alternatives will depend on the basic principles of domestic tax law in that country. This

72E.g., US Internal Revenue Code §482.

73 E.g. Japan Special Taxation Measure Act §66-4(1).

will, for example, include issues such as the form of anti-avoidance legislation and where to place the burden of proof. However, the choice of styles of domestic legislation has made no substantial difference in the legal procedure of structuring 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.

* + - 1. 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 Advance Pricing Agreements/ Arrangements (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 guid- ance should normally be available in subordinate legal materials, such as regulations, administrative rules and public notices. Therefore, even if such matters are defined in great detail in the primary tax law, there is a need to provide clear operational guidance. Users of this Manual should consider the level of guidance available in their countries, and determine if further detail is needed.
      2. There remains substantial risk of double taxation even when two countries follow the same general arm’s length principle approach. For example, such double taxation may occur where specific guidance on the implementation of the arm’s length principle is differ- ent 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.

## B .8 .3 . Associated Enterprises

* + - 1. The definition of which entities (companies, trusts, indi- viduals and other persons) and therefore transactions are covered by transfer pricing legislation is a key issue since the arm’s length prin- ciple 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 as relevant situations.

* + - 1. The requirement of control in each subparagraph is defined as being to “participate directly or indirectly in the management, control or capital of an enterprise”. There is no specific common guid- ance 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 as a threshold for triggering transfer pricing legisla- tion has in effect been left to domestic legislation.
      2. Some countries apply a 50% shareholding threshold as the degree of participation required for “associated” status; some coun- tries employ a lower threshold. However, countries with higher thresh- olds usually employ substantive rules on control as a fall-back, 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. There is thus no significant difference among countries on this matter.
      3. Differing threshold criteria can result in disputes in certain circumstances. For example, in Japan, domestic law stipulates that a shareholding of 50% or more is the threshold for an “associated enter- prise”, which is generally a possible target of transfer pricing exami- nation by tax authorities. This may bring into the examination “net” a 50/50 joint venture project organized by two independent parties.**74**
      4. In South Africa, transfer pricing rules are applied to cross border transactions between related persons, i.e. connected persons. A connected person is defined in relation to natural persons, trusts, members of partnerships and companies. Companies could be connected persons if one of the companies holds at least 20% of the equity shares or can exercise at least 20% of the voting rights in the other company. As an additional example, in Brazil the threshold of

74 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.

ownership is 10% of the company´s equity, and this also applies when a person (individual or company) owns at least 10% of the equity of the two companies involved in the transaction (the Brazilian company and the foreign company), as the TP legislation also applies the concepts of the Company Law. Brazilian TP legislation is very broad regarding the concept of “related persons”, e.g. it also considers the kinship of the individual resident in the foreign country performing commercial relations with companies in Brazil that are controlled or managed by his or her relatives (depending on the kinship grade); and all transac- tions performed with listed jurisdictions (low tax and non-cooperative jurisdictions) are subject to TP adjustments.

* + - 1. For developing countries, analysis of control might be an important challenge in ensuring that their transfer pricing legisla- tion can be administered effectively. In addition, factors for identify- ing control should be carefully examined because evaluation of those factors requires complicated fact-finding procedures which might differ depending on industry sector, geographic characteristics, prod- uct cycle, etc.

## B .8 .4 . Coverage of Transactions and Availability/ Priority of Transfer Pricing Methods

* + - 1. Transfer pricing generally covers all cross-border trans- actions involving a country, regardless of whether participants are residents or non-residents. Thus, transactions conducted between a permanent establishment (PE) of a foreign company located in a juris- diction and its affiliate company located in another jurisdiction are also taxable events under the domestic law of that jurisdiction. On the other hand, a transaction between a foreign company with a domestic PE and its affiliated company located domestically may be categorized as a non-taxable event in certain jurisdictions, such as Japan, because there is no substantial risk of income shifting beyond their borders.
      2. However, transactions between local branch offices and their headquarters are regulated by other legislation, such as non-resident/ foreign company taxation rules, and may be affected by Article 7 of bilateral tax treaties (usually based upon the UN or OECD Models). Although under such circumstances the arm’s length principle gener- ally prevails in an equivalent manner, the legal framework of taxation

should be differentiated. For example, the dispute resolution mecha- nism might be different depending on each country’s domestic law and the relevant treaty. Nevertheless, in general, the same domestic trans- fer 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), despite the fact that a tax treaty between the countries involved in the transaction may be applicable.

* + - 1. The choice of method, availability of different types of methods and the priority to be given to various different transfer pric- ing methods are matters often covered by domestic legislative frame- works. Availability and priority of the transfer pricing methods is one of the most important elements for domestic legislation. This is often done through administrative guidance or other subsidiary materials rather than taxation laws. Many countries have followed the OECD Transfer Pricing Guidelines in developing their domestic legislative frameworks, and have preferred the traditional transaction methods over transactional profit methods as a means of establishing whether a transfer price was at arm’s length. See further a detailed discussion of the methods in Chapter B.3, including that there is no longer consid- ered to be a “hierarchy” of methods and that the most appropriate method should be applied.

## B .8 .5 . Practical Guidance for Cases without sufficient comparables

* + - 1. The most critical issue for developing countries as well as developed countries when applying any methodology will often be the lack of third party comparables. Practical guidance in establishing the basic methods without sufficient domestic information on independ- ent comparables should be a key focus in domestic legislative frame- works. This area has not been addressed thoroughly in the OECD Transfer Pricing Guidelines and many of the transfer pricing regimes seen worldwide do not prescribe in detail how to address this issue. This Manual as a whole is intended to assist especially in this area; users should refer to Chapter B.2. 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 atten- tion to the new paragraphs 2.16A to 2.16E that were added to Chapter II (Methods) of the OECD Transfer Pricing Guidelines as a result of the BEPS Project dealing with the CUP method for commodities when there is a quoted price, e.g.: “Under the CUP method, the arm’s length price for commodity transactions may be determined by reference to compa- rable uncontrolled transactions and by reference to comparable uncon- trolled arrangements represented by the quoted price.”**75** See the chapter on Methods (Chapter B.3. of this Manual) for more details.

* + - 1. Ease of administration is another important issue in the design of legal frameworks. Documentation requirements supported by penalties for 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. Preparing docu- mentation is one of the most expensive compliance costs for MNEs, especially if there are differences in countries’ requirements. There is value in seeking to align documentation requirements with those of other countries, especially in the same region, unless there are good reasons in terms of reducing compliance and collection costs, or specific features of local legislation, that require differences. The OECD/G20 BEPS Project specifically focused on transfer pricing documentation and country by country reporting. In October 2015 a report providing guidance on the implementation of these measures under action 13 was published.**76**

75 OECD (2015), *Aligning Transfer Pricing Outcomes with Value Crea- tion, Actions 8-10 —2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 53. Available at [http://dx.doi.](http://dx.doi/) org/10.1787/9789264241244-en

76 See OECD (2015): OECD/G20 Base Erosion and Profit Shifting Pro- ject: “Transfer Pricing Documentation and Country-by-Country Reporting: Action 13”: 2015 Final Report available at:<http://www.keepeek.com/Digital-> Asset-Management/oecd/taxation/transfer-pricing-documentation-and- country-by-country-reporting-action-13-2015-final-report\_9789264241480- en#.V-N2wfCa0dU; further guidance was issued in 2016, available at http:// [www.oecd.org/tax/beps/beps-actions.htm](http://www.oecd.org/tax/beps/beps-actions.htm)

* + - 1. Some differences in the coverage of transactions or in the legal form (statutes with penalty provisions or administrative guid- ance on self-assessment) will remain. It is therefore appropriate to continuously evaluate documentation and penalty legislation for effi- ciency and proportionality. The experience of countries that have introduced transfer pricing rules may be relevant to developing coun- tries just starting to develop capability in transfer pricing. For exam- ple, at the initial stage of transfer pricing administration in the early 1990s, Japanese transfer pricing examiners experienced difficulties in collecting information about affiliated enterprises that was physically held overseas. Documentation requirements were very basic under Japanese domestic legislation at that time; examiners had to exercise their ordinary domestic investigation powers to inquire from taxpay- ers about international related party transactions. They soon identified that not all relevant information was necessarily kept by the Japanese unit. Japan therefore started a process of adjusting documentation requirements to reflect the actual international business practice of multinational groups by ensuring effective compliance but also taking into consideration the taxpayers’ compliance burden. See Chapter C.2. on Documentation for specific country practices.

## B .8 .6 . Burden of Proof

* + - 1. The burden of proof in tax litigation refers to the neces- sity of affirmatively proving the truth of facts alleged by a litigant on a preponderance of evidence. It is also sometimes referred to as “the risk of non-persuasion” or the “burden of persuasion”. A party meets this burden by convincing the fact-finder to view the facts in a way that favours 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 needs to satisfy both the burden of allegation and the burden of proof to win a lawsuit.
      2. The burden of proof operates in litigation. However, it is important to be able to identify the party with the burden of proof when a tax audit is conducted or when the transfer pricing assessment is made; because when a transfer pricing assessment is disputed it may ultimately end up in court.
      3. The burden of proof for transfer pricing litigation may be determined in accordance with the burden of proof rules of civil proce- dure or tax litigation in general. 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 that jurisdiction. The burden of proof rules for transfer pricing cases differ among countries. The position that the taxpayer bears the burden of proof is taken, for example, by the Australia, Brazil, Canada, India, South Africa and the United States.
      4. In the United States the taxpayer bears a two-fold burden of proof in order to win transfer pricing cases. The taxpayer must establish that (i) the Internal Revenue Service’s (IRS’s) allocation of income is arbitrary, capricious and unreasonable and (ii) the prices, royalties or other compensation in question are at arm’s length. The burden of proof is shifted to the IRS or can be removed if the IRS has raised a “new matter” not previously addressed in the notice of defi- ciency or has attempted to increase the deficiency amount relating to transfer pricing after the issuance of the notice of deficiency.
      5. In Canada the burden of proof rests on the taxpayer because it is the rule in any litigation.
      6. In Australia the burden of proof is on the taxpayer, as docu- mentation demonstrating that the terms and conditions of its transac- tions with related parties are consistent with arm’s length terms and conditions must be prepared and maintained by the taxpayer. Division 13 of the Income Tax Assessment Act 1936 gives the Commissioner the authority to determine the arm’s length price where it cannot other- wise be determined.
      7. In India the burden of proof to establish the arm’s length nature of international transactions is generally with the taxpayer. Once the taxpayer discharges this burden, the burden shifts to the tax authorities to establish that the arm’s length price has not been deter- mined in accordance with the provisions of the law or that the infor- mation or data used in the computation is not reliable or correct.
      8. In Brazil the burden of proof is on the taxpayer, who has the right to choose the method, but has the obligation to keep the appropriate documentation, and to provide additional documentation and information in the case of a tax audit. However, the burden of

proof shifts to the Tax Administration if it challenges the taxpayer’s TP adjustments (or the lack of adjustments).

* + - 1. In South Africa section 102 of the Tax Administration Act of 2011 provides that the burden of proof that: (1) an amount, transac- tion, event or item is exempt or otherwise not taxable, (2) an amount or item is deductible or may be set-off, (3) an amount qualifies as a reduc- tion of tax payable, or (4) a valuation is correct, rests with the taxpayer. Upon the hearing of any appeal to the tax court by a taxpayer against a decision by the South African Revenue Service (SARS) to disallow an objection against an assessment by SARS, the assessment may not be reversed or altered unless it is shown by the taxpayer that the basis upon which the assessment was raised is wrong. Section 129 of the Tax Administration Act requires the tax court to decide matters before it on the basis that the burden of proof as described in section 102 is upon the taxpayer.
      2. In France the tax authorities bear the burden of proof. However, if the tax authorities resort to an assessment where no tax returns have been filed the burden is reversed so as to rest with the taxpayer.
      3. In Germany the tax authorities bear the burden of proof with regard to the details and circumstances that establish or increase a tax claim. An exception to this rule applies if tax-relevant facts and circumstances cannot be assessed completely, even though the tax office has utilized all available and appropriate reasonable measures, and the taxpayer has failed to comply with its obligations to cooperate. Further, where the tax authorities are entitled to estimate the taxpay- er’s income the taxpayer has the burden of proof to show that the tax auditor’s estimate is based on false or wrongfully selected assumptions.
      4. In the Netherlands the burden of proof in transfer pricing cases generally rests with the tax authorities, provided that the taxpayer presents documentation to support the company’s transfer pricing policy and demonstrates that the application of its policy is consistent with the arm’s length principle. If the information supplied constitutes sufficient proof, the burden falls on the tax authorities to provide reasonable proof of suspected prices contravening the arm’s length standard and thereby to cause the burden of proof to shift to the taxpayer. The tax authorities must generally prove the correctness of the adjustment when making

a transfer pricing adjustment. Owing to the introduction of documen- tation requirements in the Netherlands, effective from 1 January 2002, the burden of proof for the arm’s length nature of transfer pricing shifts to the taxpayer if a taxpayer does not supply sufficient information. The taxpayer then has to provide reasonable proof that the prices are at arm’s length. As a result, not only is the burden of proof shifted but it also becomes more difficult for the taxpayer to establish its position. The State Secretary for Finance has further observed that the taxpayer is not required to complete a survey or study concerning transfer prices in comparable situations between unrelated parties. The lack of a study will not lead to a reversal of the burden of proof.

* + - 1. In Japan the government has the burden of proof when a taxpayer seeks to overturn an assessment of the government through litigation, including a transfer pricing adjustment, which restricts the constitutional freedom of, or imposes an obligation on, the taxpayer. In principle the government bears the burden of proof with respect to the existence of revenues and the non-existence of necessary expenses in tax litigation, provided that the court may exercise discretion in making factual assumptions when it believes that those assumptions are warranted by the facts. The burden of proof may be reversed when the taxpayer fails to produce records to enable the tax administra- tion to undertake its examination of whether the arm’s length require- ments are complied with. The tax administration is then empowered to estimate the taxpayer’s income in accordance with the apparent arm’s length principle. The burden of proof rules in Japan have been developed in more detail through several court decisions on transfer pricing taxation. For example, in its judgment of 30 October 2008 on the *Adobe* case the Tokyo High Court held that the tax authorities bore the burden of proof for showing that they had applied the Resale Price Method correctly.**77**

77 In this case the tax authorities compared the personal services func- tion of the tested party (the Japanese subsidiary that was paid by its foreign parent company for performing personal services to assist the parent com- pany’s unrelated distributor in Japan) with the resale function of comparable enterprises in the same industry. The court, however, was not persuaded by the tax administration’s presentation of such comparables for the reason that the offered comparables lacked proper comparability because sales activities are different from service activities.

* + - 1. Tax administrations and taxpayers may encounter several challenges in meeting their respective burdens of proof. As a practi- cal matter, associated enterprises normally establish the conditions for a transaction at the time the transaction is undertaken. In audit- ing these transactions, the tax administration may have to engage in a verification process perhaps some years after the 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 signif- icant numbers and types of cross-border transactions. The tax admin- istration 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 may also need to gather infor- mation on the comparable uncontrolled transactions and the market conditions at the time the transactions took place, for numerous and varied transactions. Such an undertaking usually becomes more diffi- cult with the passage of time. Both taxpayers and tax administrations therefore often have difficulty in obtaining adequate information to apply the arm’s length principle.
      2. The divergent rules on the burden of proof between two countries engaged in a MAP may cause difficulty in reaching a MAP agreement. In such event, neither the treaty partner countries nor the taxpayers should misuse the burden of proof. Tax adminis- trations as well as taxpayers should exercise good faith in showing that their determination of the transfer price is consistent with the arm’s length principle regardless of which party bears the formal burden of proof.
      3. It should be noted that in practice the burden of proof is not always a deciding factor. The burden of proof requirement never- theless plays an important role in deciding who should disclose what. Since burden of proof is a general issue stipulated in 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.

## B .8 .7 . Presumptive Taxation Approaches and the Arm’s Length Principle

* + - 1. A “presumptive taxation” approach is provided for in the law of some countries. Presumptive taxation provisions, such as those of Japan, give tax authorities the power to “presume” an arm’s length price based on information gathered by the authorities, and to reas- sess 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 documentation on the arm’s length price within a reasona- ble time (such as when information is requested of a taxpayer during an audit). Presumptive taxation is usually provided for as a last resort.
      2. This methodology may be common in legislation operat- ing in relation to domestic taxation and transfer pricing adjustments. However, transfer pricing adjustments in relation to foreign trans- actions generally create a risk of international double taxation. Most countries therefore structure such legislation carefully in a manner consistent with the arm’s length principle. However, it seems that some countries lower the threshold for applying this methodology, at least in terms of establishing comparable transactions. Once again, the Japanese experience can be useful.
      3. To invoke presumptive taxation in Japan, the statute allows the tax authority to use the Resale Price Method or the Cost Plus Method by utilizing the gross profit ratio found in a company in the same industry. After the adjustment by presumptive taxation the burden of proof is shifted to the taxpayers, who have to show that their prices and not the National Tax Agency’s presumed prices are at arm’s length.
      4. As stated earlier, Japan introduced the examiners’ author- ity to inquire into third party transactions at an early stage of its trans- fer pricing journey. The condition to make use of this authority is that when examiners request a taxpayer to provide records, books or copies thereof, which are recognized as necessary for computing the arm’s length price, the taxpayer does not provide those materials in a timely fashion. The meaning of the terms “relevant materials” and “in a timely fashion” has caused some disputes, when taxpayers have insisted that they have performed all their minimum obligations on the disclosure of basic information to support their methodologies. The focal point of

discussions has been whether the burden of proof is on the tax admin- istration or on taxpayers. The question of whether presumptive taxation has been properly applied will determine whether the burden of proof has shifted from being on the administration to being on the taxpayer.

* + - 1. The utility of presumptive taxation methods depends on which structure of the two choices noted above (assessment by the authorities/ tax administration or self-assessment) the country concerned employs. Under a self-assessment system such as in Japan, where the tax authorities always have the burden of proof whenever they propose an adjustment, presumptive taxation may appear more attractive. 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. This type of presumptive taxation is not the same as the fixed margins methodology of the Brazilian legislation, which is a simplification of the arm´s length principle for the Resale Price and Cost Plus methods (see Chapter D.1.).
      2. Another issue closely related to presumptive taxation, but relevant to other systems also, is the use of “secret comparables”. Once examiners make an inquiry into third party transactions, the acquired data relating to those transactions is generally confidential under the tax laws, because any information is provided by such third parties under conditions of confidentiality. Therefore, during the dispute procedure, the taxpayers in relation to whom presumptive taxation is applied cannot access any materials which form the basis of the presumptive taxation. In order to secure an opportunity for taxpayers to defend their position against such taxation the OECD Guidelines advise that it would be unfair to apply a transfer pricing method on the basis of such secret comparables unless the tax administration is able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer. Disclosure of the data would provide an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts.**78**
      3. In some systems, information is called for from compara- ble companies to ascertain the correct factual position regarding their

78 OECD Transfer Pricing Guidelines at paragraph 3.36.

financial transactions or functional profile. This information may be in addition to information already publicly available with respect to the company. However, if such information is used against a taxpayer for determination of the arm’s length price in a particular case, this is invariably notified to the taxpayer and an opportunity is granted to the taxpayer to offer a rebuttal against the use of such information.

## B .8 .8 . Safe Harbour Rules

* + - 1. Safe harbour rules are rules that apply to a category of transactions, allow a defined category of taxpayers to follow a simple set of prescribed transfer pricing rules, or exempt taxpayers from the application of the general transfer pricing rules. These rules could be limited to taxpayers with reported profits below a threshold amount, expressed as a percentage or in absolute terms. This simpler mecha- nism to establish tax obligations can be relied upon by a taxpayer as an alternative to a more complex and burdensome rule, such as applying the transfer pricing methodologies. There are other types of simplified mechanism for transfer pricing that the countries concerned also cate- gorize as safe harbours. For example, another simplified mechanism sometimes used enables a company to avoid making a transfer pric- ing adjustment where the ratio between international transactions and the overall transactions of a given company is smaller than a percent- age stipulated in the law or regulation. A safe harbour cannot normally be used to the disadvantage of a taxpayer—it is generally regarded as applicable only at the election of the taxpayer.
      2. Safe harbour rules can be an attractive option for devel- oping countries, mainly because they can provide predictability and ease of administration of the transfer pricing regime by a simplified method of establishing taxable profit. Supporters of this type of rule point to the advantages of simplifying compliance, lowering compli- ance costs and providing certainty for taxpayers, as well as adminis- trative simplicity for tax authorities.
      3. It is often stated that safe harbours allow tax administra- tions (especially when they are just beginning to administer transfer pricing laws) to focus their limited resources, including audit resources, on the more complex and higher risk cases of non-arm’s length trans- fer pricing, especially high-margin transactions. Given the difficulties

of information collection and analysis of data many developing coun- tries might consider that at least for smaller taxpayers or less compli- cated transactions safe harbour rules contribute to minimizing the complexity of establishing an arm’s length price, which requires collec- tion and analysis of data. The complexity might be disproportionate to the size of the taxpayer or its level of controlled transactions.**79**

* + - 1. Safe harbour rules may also be useful in relieving SMEs of compliance burdens that disproportionately affect them as compared to MNEs (and may affect their ability to compete). In the case of MNEs, such rules can relieve similar compliance burdens in relation to small transactions, creating a better investment climate. For example, safe harbours can decrease the MNEs’ compliance burdens to some extent by their application to a certain class of transactions within a certain defined threshold, such as low value-added services**80** and interest rates in respect of short-term inter-company “plain vanilla” (i.e. on standard terms) loans of moderate value.
      2. There are possible downsides to safe harbours, including the possibility of abuse. An example of such abuse is breaking down what is in reality a large transaction into several smaller ones. There is also a risk that taxpayer lobbying efforts will make it difficult to remove safe harbours when capabilities have improved and they are no longer needed, or when conditions have changed so that they are no longer appropriate. There is also the possible risk that safe harbour rules are too generous; this can possibly result in revenue unneces- sarily foregone. This will also be the case if transactions that would otherwise have been concluded at lower 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 to which the safe harbours will not apply. Safe

79 OECD Transfer Pricing Guidelines at paragraph 4.94 to 4.101.

80 See the Communication from the Commission to the European Parlia- ment, the Council and the European Economic and Social Committee on the work of the EU Joint Transfer Pricing Forum in the period April 2009 to June 2010 and related proposals: (1) Guidelines on low value adding intra-group services and (2) Potential approaches to non-EU triangular cases available from <http://www.transferpricing.com/pdf/EU_Communication01252011.pdf>

harbours may thus even discourage investment in high-margin activ- ity as compared to low-margin activities.

* + - 1. The section on safe harbours in Chapter IV of the OECD Transfer Pricing Guidelines, updated in May 2013, 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 prin- ciple, 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 in the transfer pricing area. In conclusion it is recom- mended that where safe harbours can be negotiated on a bilateral or multilateral basis, they may provide significant relief from compli- ance burdens and administrative complexity without creating prob- lems of double taxation or double non-taxation. It is also stated that country tax administrations should carefully weigh the benefits of and concerns regarding safe harbours, making use of such provisions where they deem it appropriate.**81**
      2. On the issue of the practical application of safe harbour regimes, the experience of the Republic of Korea represents a relevant example. Before joining the OECD, the Republic of Korea’s national tax authority, the National Tax Service (NTS), employed a so-called “standard offer-commission rate” for import and export business taxa- tion. Under this scheme, the NTS used a standard offer commission rate based on a survey of actual commission rates. This was available as a last resort under its ruling only in cases where other methods for identify- ing the arm’s length rate were inapplicable in determining commission rates charged by a foreign party. The NTS finally repealed this ruling as it considered the ruling to be contrary to the arm’s length principle.
      3. Safe harbour provisions were introduced in India in the Indian Income Tax Act with effect from 1st April 2009. The relevant rules were notified on 18 September 2013 after detailed consultation with all the stakeholders. These provisions were applicable to all eligible taxpayers and eleven categories of eligible international transactions on the basis of an option exercised by such taxpayers. The sectors covered

81 OECD: Revised Section E on Safe Harbours in Chapter IV of the Trans- fer Pricing Guidelines <http://www.oecd.org/ctp/transfer-pricing/Revised-> Section-E-Safe-Harbours-TP-Guidelines.pdf

under the safe harbour rules are: software development services; infor- mation technology enabled services; knowledge process outsourcing services; advancing intragroup loans; provision of corporate guaran- tees; contract research and development services relating to software development; contract research and development services relating to generic pharmaceutical drugs; and manufacturing and export of core and non-core auto components. The option of a safe harbour validly exercised by the taxpayer is expected to be in force for a specified period as opted for by the taxpayer or for a period of five years, whichever is less.

## B .8 .9 . Adjustments

* + - 1. A taxpayer may seek, on examination, a reduction in a transfer pricing adjustment based on an unintentional over-reporting of taxable income. However, no clear guidance in this regard is found in the OECD Transfer Pricing Guidelines. The only guidance available indicates that tax administrations may or may not grant the request for downward adjustment at their own discretion.**82** It adds that tax administrations may also consider such requests in the context of MAPs and corresponding adjustments. This is an issue which develop- ing countries should also consider when designing their domestic legal environment for transfer pricing.
      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 multi- ple year data. Therefore, tax officials are no longer given any discre- tion 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.
      3. In South Africa the legislative provision that requires that terms 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 where the taxpayer derives a tax benefit. The over-reporting of taxable income would not fall within the mean- ing of a tax benefit.

82 OECD Transfer Pricing Guidelines at paragraph 3.17.

## B .8 .10 . Advance Pricing Agreements/Arrangements

* + - 1. APAs have been introduced in many countries to confirm the arm’s length result in advance by agreement between taxpayers and tax authorities on certain sets of criteria (transfer pricing methods, comparables and appropriate adjustment thereto, critical assumptions as to future events, etc.). To a great extent, APAs have reduced transfer pricing adjustment risks for multinationals, especially under bilateral APAs involving two countries, and therefore the number of applica- tions for APAs has reached almost the number of adjustment cases in some developed countries.**83** On the other hand, although unilat- eral APAs are categorized as partial solutions for double taxation, they are also considered useful in specific cases depending on all the facts and circumstances. The OECD Transfer Pricing Guidelines strongly endorse APAs as a supplement to the traditional administrative, judi- cial and treaty mechanisms for resolving transfer pricing issues.**84**
      2. One of the key advantages of adopting an APA system is that uncertainty can be eliminated through enhancement of predict- ability of the taxation of international transactions. Developing coun- tries thus have a good opportunity to obtain access to the existing documentation which is relevant to their local operations. A second advantage is that APAs can provide an opportunity for both tax admin- istrations and taxpayers to consult and cooperate in a non-adversarial spirit and environment. As a third advantage an APA may prevent costly and time-consuming examinations and litigation of major 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 inter- national transactions undertaken by MNEs.**85**

83 From July 1, 2015 to June 30, 2016, Japan received 149 applications for APAs, whereas it adjusted 240 cases after examination for the same period.

84 OECD Transfer Pricing Guidelines at paragraphs 4.123 to 4.165. In addition, see the Annex to Chapter 6 on “Guidelines for conducting APA under the MAP”.

85 OECD Transfer Pricing Guidelines at paragraph F.3 Advantages of advance pricing arrangements

* + - 1. Some consider adequate levels of experience to be neces- sary before the appropriate type of APA can be achieved, 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 operational capability of the transfer pricing regime is thus an important factor in the design of the domes- tic legal environment.
      2. 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.**86** 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 taxpay- ers and is not subject to abuse or integrity issues. The advantages and disadvantages of APAs are discussed in more detail in Chapter C.4. on Dispute Resolution and Avoidance: it may, however, be noted that consideration must be given to the inclusion of an APA programme at different stages of the design of a legal framework for transfer pricing.

## B .8 .11 . Dispute Resolution

* + - 1. As stated earlier, an upward transfer pricing adjustment generally causes substantial double taxation for the cross-border busi- ness, unless there is a “corresponding adjustment” downward by the other party to the transaction—i.e. by the other country’s tax author- ity. For this purpose, countries should take into consideration domestic dispute resolution procedures as well as treaty-based dispute resolu- tion mechanisms when designing a transfer pricing regime. Domestic

86 After almost a decade of experience of implementation of transfer pric- ing regulations in the country, India introduced APAs with effect from 1st 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 100 uni- lateral and bilateral APAs.

remedies are expected to work effectively for transfer pricing cases, if a transfer pricing adjustment lacks a domestic legal basis. However, even when a taxpayer partially wins the case, the double taxation aris- ing from an adjustment is still not recovered unless the MAP works successfully to reach agreement on the arm’s length result between the treaty partners, with one treaty partner making a corresponding adjustment in its jurisdiction. In addition, a bilateral APA not only plays a major role in the confirmation of future taxation but also in relation to past taxation. The roll-back system for APAs is accepted by many countries, where the tax authority decides that the agreed trans- fer pricing method is also appropriate for past open years, considering all the facts and circumstances. Thus, dispute resolution based upon the MAP provision in tax treaties (usually based upon Article 25 of either the UN or OECD Model) has become one of the most important procedures for taxpayers.

* + - 1. Article 25 of the OECD Model Tax Convention was revised in 2008 to introduce the possibility of arbitration of unresolved MAP issues. In addition to guidance on how to reach a conclusion when dealing with these issues, it ensures that the Competent Authorities seek to resolve issues within a reasonable period of time, something which has not always happened in practice. Some issues for developing countries, when considering the possible use of arbitration or when asked to consider it by a potential treaty partner, are addressed in the Commentary to Article 25 of the UN Model. Alternative versions of the Article, with or without arbitration, are included for consideration depending on the preferences of treaty partners. The substantive issues regarding MAP are discussed in Chapter 4 of Part C; however, for the purposes of the present chapter, the need to accommodate treaty obli- gations and processes should be taken into account in the design of the legal environment.
      2. For most developing countries, arbitration is a new issue to be addressed. The reality is that for a long time only a very small number of cases will be covered by a bilateral treaty with an arbitra- tion provision, especially in the case of treaties where the other party is a developing country. Moreover, even when an arbitration clause exists in the Article related to MAP, it is essential that the MAP itself is operating as efficiently and effectively as possible.
      3. One issue experienced by some developing countries is that there is insufficient current experience in negotiation with other competent authorities on transfer pricing matters. Competent Authorities in developing countries have to face some difficult condi- tions at the initial stage of the design and implementation of the transfer pricing regime. There may be differences between the two Competent Authorities’ abilities to access information on transfer pricing meth- ods; and there may also be limited information available to the local entity while the related party may have access to more and better data. However, this may be resolved through effective exchange of informa- tion. A further problem is the lack of experience in conducting a MAP in transfer pricing cases.
      4. The Japanese experience can be considered as one refer- ence point. At the initial stage of engaging in MAPs Japan experienced the disadvantages listed above. However, after developing effective partnerships with many treaty partners a large amount of informa- tion was successfully shared. Intensive and practical discussions on the transfer pricing methods or comparability analysis thus improved the capacity of Japan’s Competent Authority. So far, although there were exceptional cases with a negotiation period beyond two years, the majority of MAP cases have been successfully concluded approx- imately within the two-year period which is now included as a target period in Article 25(5) of the OECD Model Convention. After stabiliz- ing its own capacity building for MAP, Japan has made some contri- butions in this area, bilaterally or multilaterally, for the benefit of new negotiating partners.
      5. The Indian experience in this regard has been somewhat similar. The Indian Competent Authority has been successfully nego- tiating with treaty partners for the settlement of cases under MAP. After years of experience gained from negotiations with treaty part- ners and improvements with regard to the exchange of information, the Indian Competent Authority has been successful in concluding settlements of large cases.

# Part C

**PRACTICAL IMPLEMENTATION OF A TRANSFER PRICING REGIME**

## C .1 . ESTABLISHING AND UPDATING TRANSFER PRICING REGIMES

**C .1 .1 . Introduction**

## Overview of Part C

* + - * 1. Part C of this Manual addresses the practical implementa- tion of transfer pricing rules in a particular jurisdiction guided by the legislative design considerations outlined in Chapter B.8. This Chapter, C.1., provides guidance on

How the considerations and the substantive issues raised in Part B can be implemented in a national transfer pricing regime through laws and subsidiary regulations;

How national transfer pricing regimes relate to domes- tic tax laws;

The position of transfer pricing rules within the overall frame- work of international tax rules within that domestic regime; and

How to keep the newly implemented transfer pricing regime updated, and administer it on a daily basis.

* + - * 1. The Chapters that follow in Part C then deal in depth with specific areas of implementation and administration. Chapter

C.2. covers the documentation requirements central to a transfer pric- ing regime, transparency issues and exchange of information, in an increasingly complex business environment discussed in detail at Part A. Chapter C.3. discusses transfer pricing audits and provides guidance on approaches to managing audit programmes and capac- ity. Chapter C.4. provides detail and approaches to dispute resolution techniques, including how to access dispute resolution systems.

* + - * 1. Chapter C.5 then brings together these issues for a tax administration in a developing country to provide approaches to build capacity within the tax administration. Part C thus aims to provide a set of approaches by which a tax administration in a developing coun- try can introduce and sustain a transfer pricing regime that meets international standards.

## Key considerations in the design of the transfer pricing regime

* + - * 1. Two different approaches are broadly discussed at B.8.2.4, to implement the arm’s length standard with respect to related party transactions, namely:

Incorporate the arm’s length principle, as well as other guid- ing transfer pricing principles into the income tax legislation, with the detailed transfer pricing guidelines expressed as Regulations, Rules or other subsidiary legislation.

Incorporate the full transfer pricing regime into the income tax system. A typical approach may see the transfer pricing regime being incorporated in a Supplementary law, regulated in Law and further explained in an Administrative ordinance. All fea- tures of the regime are thus legal in nature.

Irrespective of which approach is taken in policy design, the measures need have the full force of domestic tax law.

* + - * 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 administra- tion to process and respond to the information received, if required.
        2. Disclosure requirements included in legislation may be voluntary, as 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 voluntarily inform the tax administration of the existence of a related party transaction, and to provide the details of that transaction.
        3. On the other hand, the legislation may require the taxpayer to retain the information and provide it 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 asked by the tax administration to demonstrate that.

* + - * 1. An example of voluntary information requirements on transfer pricing in filing the annual income-tax return is the related party transactions reporting form. A specific example is the Australian International Dealings Schedule that has to be filed with the annual corporate income tax return. Another example is the Brazilian Corporate Income Tax Return (Declaração de Informações Econômico-Fiscais da Pessoa Jurídica, (DIPJ)) where the taxpayer is required to voluntarily report all transfer pricing transactions taking place within a period or annual basis (depending on the taxpayer’s reporting schedule). Taxpayers are required to report certain transac- tions with non-residents as they arise through these forms. The South African transfer pricing questionnaire, required to be submitted with the annual corporate tax return, is a good non-OECD example.
        2. The voluntary disclosure of information is the most suit- able 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 infor- mation a function of the transfer pricing legislation so that the obliga- tion to report derives directly from the main legislation (without any additional administrative requirements). That will provide tax admin- istrations 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 audit the information, if required.

## Balance to be struck between statute and subsidiary regulations

* + - * 1. As mentioned in C.1.1.1, above, some tax systems contain a general recognition of the basic aspects of a tax obligation, and then issue extensive regulations explaining how the rules would apply in practice. This essentially means recognizing the arm’s length princi- ple and the basic principles applicable to transfer pricing through the primary legislation.
        2. This is the case in the United States, for example, where the substantive provisions are included in the Internal Revenue Code (IRC) Section 482, and then extensively regulated in the Treasury Regulation Section 1.482 –1 through Section 1.482 –9. Legislative and procedural regulations have the weight of law in the United States, and are bind- ing on the taxpayer. Therefore, even though the IRC only provides the foundation to the transfer pricing principle, the obligation to observe transfer pricing rules and the determination on how to observe it is mandated by the regulations.
        3. Sometimes domestic tax systems are not able to confer the appropriate weight of authority to the accompanying regulation (as a result of the way the domestic tax system is organized or the legal system), but the bulk of the regulatory provision is, nevertheless, only included in regulation. That is the case in Belgium, and in several other European countries. The arm’s length principle was formally introduced into Belgian tax law by adding a second paragraph to section 185 of the Income Tax Code in the second half of 2004. As in the USA, only the founding principle is foreseen in statute. The bulk of the regulation is contained in administrative guidelines (circular letters). Administrative guidelines are binding for the Belgian tax authorities, but not on the taxpayers who, in theory, can tax plan around those rules. Therefore the taxpayer can rely on those rules but is not bound by them.
        4. India has applied a more balanced approach where Sections 92 to 92F of the Income Tax Act, 1961 outline the statutory principles that are then amplified in Rules 10A to 10E of the Income-tax Rules,1962. E.g. Sec. 92C covers determination of the arm’s length price while Rule 10B amplifies the principles to be followed.
        5. On the opposite side of the spectrum is Brazil, where all of the transfer pricing system is regulated through primary legislation (Supplementary Laws, Ordinary Laws, Normative Ordinances and Administrative Acts) and therefore it is binding on the taxpayer and the tax administration.
        6. Developing countries should assess which system is most suitable considering their own domestic tax legislation and the level of complexity they want to assume through the application of the transfer pricing legislation. Objective statutory provisions tend to provide greater certainty because they are binding on taxpayers and

the tax administration. They are also likely to provide fewer margins for dispute, making the system simpler, which in turn puts less pres- sure on already limited human resources from the tax administra- tion. Consideration should also be given on the status of rulings; e.g. in Australia they are administratively binding on the tax administra- tion, but not on the taxpayer.

## Transfer pricing organization in tax administration

* + - * 1. An important part of implementing a transfer pricing regime is determining which part of the tax administration should undertake transfer pricing work. The typical options are:

Creating a transfer pricing department or division, tasked with the responsibility to handle all transfer pricing work arising from the application of the rules;

Placing the transfer pricing work within an international opera- tions 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.

* + - * 1. In addition to one of the three above options, tax admin- istrations also have the option of creating specially designated depart- ments within other departments, to deal with high profile cases, special cases, or with certain groups of taxpayers. In this case, coun- tries might consider also creating the following sub-departments:

Placing the work within a LTU/LTO (Large Taxpayers Unit/ Office) 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 susceptible to transfer mis-pricing—e.g. pharmaceuticals, oil and gas, automotive, etc.

* + - * 1. The choice to be made by a particular country will depend on its particular circumstances and capacity available. The choice may also be dynamic, i.e. as capacity is developed along the lines suggested at Chapter C.5. 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 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. See further Chapter C.3.2. for a detailed discussion on audit capability.

* + - * 1. LTU/LTOs have been implemented across the world, and allow the tax administration to create centres of competence dealing with separate taxpayer types. Such units are often part of a reformed administration that includes structuring the administration along functional lines, focusing on the taxpayer as the administration’s ‘customer’ the minimization of whose compliance cost is often a prin- cipal objective of the administration. It is quite common to allocate the transfer pricing inspection division to the LTU/LTO which is then considered the central repository of experience.
        2. Such an allocation of responsibilities can foster evolutionary, learning approaches. A good example is Brazil where the transfer pric- ing programme in the LTO (known as the DEMAC) focused its audits mainly at specific sectors such as pharmaceuticals and automobiles. However, as the audit teams grew in sophistication in their approaches, and as they grew in number and experience, the focus became wider.
        3. Finally, the design of a good tax administration must include an effective audit program capable of detecting and penaliz- ing non-compliant taxpayers. Such an audit programme could grow out of a larger compliance team, and could include industry and/or issues oriented audits, comprehensive regular audits of specific busi- nesses that fall within risk criteria and fully fledged tax fraud investi- gations. Joint investigation programmes for corporate income tax and GST non-compliance can also be planned by more sophisticated tax administrations. See further Chapter C.3.
        4. Open consultation with business and stakeholders prior to implementation or modification of a particular piece of legislation may also help create more common understanding between the taxpayer and the tax administration. This will help avoid potential future disputes by allowing time for taxpayers to foretell the issues that might cause greatest concern in the legislation about to be implemented.
        5. Use of information and communication technology (ICT) in tax administration is now a central part of capacity development. 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, and automated communications which might include online access to templates, case studies, step-by-step guidelines (even if informal guidelines of no legal status), explanation of legislative changes, publication of pre-selected information geared towards specific indus- tries or types of taxpayers (e.g. leaflets reporting on information perti- nent to small and medium enterprises, a separate information leaflet for large taxpayers, one for car makers, pharmaceuticals, etc.). Automation of processes would 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 confi- dence and increase simplicity; they may also support anti-corruption initiatives and improve perceptions.

## C .1 .2 . Transfer Pricing Rules in National Tax Regimes

* + - 1. **Domestic rules**
         1. The Associated Enterprises article (Article 9) of tax trea- ties sets out the basic conditions for transfer pricing adjustments and for corresponding adjustments where there is a risk of double taxation. Although Article 9 advises the application of the arm’s length princi- ple 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 detailed domestic legislation to implement transfer pricing rules. Often countries apply their domestic transfer pricing rules only to cross-border transactions. See B.1.7. for an exhaustive discussion of the substantive principles in this regard.
         2. There are variations between countries in the definition of an “associated enterprise” based on factors such as the domestic legal system and circumstances of the country. The definition often uses a number of factors such as a minimum shareholding level or effec- tive control of financial, personnel, trading conditions or other factors.

There may also be a de minimis criterion under which related party transactions only come within the transfer pricing rules if they reach a certain amount. Although international consistency in the defini- tion of associated persons 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 frame- work, treaty obligations and resources. This can also be an evolution- ary process; as the country develops its transfer pricing regime, it will also need to ensure that the administrative rules in, for example, a Taxes Management Act are simultaneously kept up to date.

* + - * 1. Some countries may include safe harbour rules to exempt taxpayers meeting certain defined 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 and are incompatible with the arm’s length principle. There is also a risk of double taxation where rules differ between countries. For further discussion see section B.1.7.5. Some key points to be considered in this regard are outlined below. These are not exhaustive features of a devel- oping country regime, but they tend to be the most problematic issues faced by a tax administration:

The application of safe harbours for juridical certainty;

The documentation requirements, which can also make or break a transfer pricing system; and

The time limits for application of the legislation.

## Interaction of transfer pricing provisions with other cross-border rules

* + - * 1. In designing a domestic tax system consideration must be given to the interaction of transfer pricing rules with 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 on the resident shareholders. It is widely considered that the transfer pric- ing 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 (see section B.1.7.7).

* + - * 1. It may sometimes be more advantageous for tax purposes to finance a company by way of debt than of 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 provi- sions have been introduced to deny a deduction for excessive interest payments. This is done by prescribing a maximum debt to equity ratio and disallowing a proportion of interest payments if debt exceeds this maximum level (see section B.1.7.8). These rules protect the tax base by discouraging cross-border shifting of profits through excessive inter- est payments on debt. If transfer pricing rules also apply to interest on related party financing the arm’s length principle may be applied to intragroup financing before the application of thin capitalization rules.
        2. Some countries that do not have very detailed transfer pricing rules in place may deal with abusive forms of transfer pric- ing 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 which may therefore prefer detailed transfer pricing legislation, regulations or guidance.

## C .1 .3 . Keeping Transfer Pricing Regimes Updated

* + - 1. **Gathering Information**
         1. This section provides information to developing coun- tries 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 after it has implemented 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 the existing intergovernmental agencies

* + - * 1. One of the suggested approaches to keep up to date with developments in international transfer pricing legislation is to engage with regional intergovernmental agencies such as CREDAF, International Organization of Tax Administrations (IOTA), Inter-American Centre of Tax Administrations (CIAT), the African Tax Administration Forum (ATAF), Study Group on Asian Tax Administration and Research (SGATAR), and the Commonwealth Association of Tax Administrators (CATA).
        2. These are non-profit international public organizations that can provide specialized technical assistance for the moderniza- tion 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 grouped through similar characteristics. Some countries are members to more than one regional organisation.**87**

CIAT’s predominant membership is from the Americas,**88**

ATAF’s membership is primarily of African countries,

SGATAR’s membership is located in the Asia-Pacific region and is currently composed of 17 member tax administrations.

CATA’s membership currently includes 46 Commonwealth countries spread over all geographic regions of the world.

### Engage with Institutional Stakeholders

* + - * 1. The United Nations, OECD, World Bank and the IMF are all agencies who consistently engage with countries providing capac- ity development. Countries generally need to apply to those agencies,

87 For example Australia, is a member of both SGATAR and CATA.

88 There is a special category of associate member. CIAT’s General Assem- bly 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.

seeking training which may be specific to the requesting country, or may be provided regionally, as part of a larger group of tax administra- tors. Following the work of the United Nations and the OECD is key to keeping domestic transfer pricing regimes updated. Engaging in inter- national tax dialogues is also a means to obtaining updated informa- tion with respect to the latest developments in transfer pricing.

* + - * 1. 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 them- selves face difficulties in compliance and policy formulation. The United Kingdom’s HMRC, South Africa’s SARS, the Brazilian Receita Federal, the United States’ IRS, and the European Commission (within the European Union) are all very sophisticated bodies which provide guidance on policy and on their own interpretation of certain interna- tional tax provisions.**89** These national tax administrations and others could be followed and even consulted by developing nations wishing to resolve perhaps similar problems arising as a result of the applica- tion of their own transfer pricing rules.
        2. Finally, some academic institutions, research centres and think tanks have funds to invest in capacity development in develop- ing countries, and encourage their experts to provide such assistance.

### Create a Clearing House for information and capacity development with like-minded countries

* + - * 1. 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.
        2. By acting within an organized group, tax administrations can share training expenses while promoting capacity development, disseminate knowledge, organize joint seminars, share the contents of training received from intergovernmental institutions such as the IMF, OECD the UN and the World Bank, and also bid for capacity devel- opment funding from donor agencies, foundations and agencies. The

89 Some of them are not available in English.

World Bank has issued a number of Toolkits for tax administrations in developing countries, which should be an important resource in capacity development.

### Participate in the South-South Dialogue for capacity development

* + - * 1. In general, tax authorities in developing countries lack suffi- cient qualified and experienced resources to understand the concerns of MNEs and to deal with controversial transfer pricing issues, espe- cially in view of global developments around new, rapidly develop- ing topics such as BEPS. Regular training, information exchange and experience sharing is necessary for capacity development. A knowl- edge sharing platform with other tax authorities (a regional institu- tion, or a clearing house institution) could be an important step in this regard. International secondments to gain more practical experience at the United Nations, the OECD or in another tax administration should be considered if possible. An independent external consul- tancy body might also be an option, as explained below. Other capac- ity development issues are covered in detail at Chapter C.5.
        2. A higher risk of unnecessary miscommunications between taxpayers and revenue authorities on some less important points 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. These experts could assist, e.g. revenue authorities and taxpayers in advanced dispute reso- lution 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.
        3. 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 a South-South Dialogue.

## Updating national tax legislation

* + - * 1. This section seeks to provide advice on the instruments that exist for tax administrations to introduce unilateral policies that

draw upon the current international discussions, without having to go through the whole legislative process in modifying tax legislation that might at times be controversial or suit purposes other than trans- fer pricing.

### Advance Pricing Agreements

* + - * 1. As previously mentioned in Chapter B.8., para. B.8.10.1., unilateral APAs tend to be tailored agreements between the tax author- ity and one taxpayer. It is an instrument through which countries can pre-determine, in agreement with the taxpayer, the result of the appli- cation of the arm’s length standard to a particular transaction or sets of transactions, based on certain sets of criteria (transfer pricing meth- ods, comparables and appropriate adjustment thereto, critical assump- tions as to future events, etc.).
        2. Many countries have introduced APA procedures in their domestic laws through 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. The possible advantages and disadvantages of APAs for developing country administrations and taxpayers, including some implementa- tion issues, are addressed in Chapter C.4.
        3. APAs have, to some extent, reduced transfer pricing adjustment risks for multinationals, especially under bilateral APAs involving two countries, and therefore the number of applications for APAs has reached almost the number of adjustment cases in some developed countries. This, however, is not true for developing coun- tries. There are only a few APAs signed, often unilateral and often for outbound, developing country headquartered companies. Developing country tax administrations tend to be less comfortable signing APAs on cross-border transactions, due to the increased risk and complexity inherent to those transactions. Bilateral APAs are seldom negotiated; it thought that limitation of resources and the lack of practical experi- ence are the main reasons for this.
        4. Developing countries could use unilateral, as well as bilat- eral, APAs as an instrument to be able to adapt existing transfer pric- ing legislation to specific, unique cases. It is a useful instrument to

avoid disputes involving an extemporaneous tax adjustment;

reduce the manpower employed towards tax auditing procedures;

be able to forecast how much tax revenue can be collected as a result of the application of transfer pricing rules in any given year; and

improve the relationship between the taxpayer and tax administration.

### Tax Rulings

* + - * 1. Tax rulings work very similarly to APAs. The difference between them is that a tax ruling can be granted on any tax issue, and an APA relates only to the application of transfer pricing regulations. As under the APA, tax rulings tend to grant greater legal certainty to the tax system by establishing, a priori, a tax rate, or a modified tax base, or by recognizing a taxpayer’s unique circumstances. A ruling may also be used to attract foreign direct investment, assuming that the tax administration uses the tax ruling to grant more favourable tax treatment to a specific taxpayer.
        2. Tax rulings also help create an active tax dialogue between taxpayer and tax administration and stimulate greater cooperation to the extent both parties fix an understanding to pay or not to pay certain taxes. Since tax rulings are tailored towards a specific taxpayer or group of taxpayers, they can also have the effect of modifying the domestic tax legislation of a country through a “special proceeding,” suitable only for a particular situation or taxpayer, without having to modify the entire legal tax system of a country. To that extent, and because the legislative process runs a lot more slowly than the confer- ral of an administrative decision, it might be helpful in allowing coun- tries 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.

### Establish an International Consultancy Body

* + - * 1. Developing countries might benefit from establishing a third party 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. A third party 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 legisla- tion for improvement.

* + - * 1. Developing countries should, through participation in regional and global dialogues, be able to benefit from the use of exist- ing consultancy bodies, used by countries with similar legislation, or countries located within the same geographic region. This should 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 organi- zation to further manage costs. Regional organizations, such as ATAF, are known to have also provided similar capacity for their member countries.

## C .2 . DOCUMENTATION

**C .2 .1 . Introduction**

* + - 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 infor- mation necessary to conduct an informed transfer pricing risk assess- ment; and (iii) provide tax administrations with useful information to use in evaluating a taxpayer’s transfer pricing positions upon audit, thereby contributing to the avoidance of many disputes and to the timely resolution of any transfer pricing disputes that may arise.

* + - 1. In the period from 2013 to 2015, the OECD/G20 BEPS Project has included an effort to create a more consistent and useful documentation standard for use by countries. Insofar as possi- ble, countries should conform their transfer pricing documenta- tion requirements to established international standards in order to limit compliance burdens imposed on taxpayers. When these inter- national 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.
      2. 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 goal of the chapter is to provide practical guidance on these documentation related issues.

## C .2 .2 . International Guidelines on Transfer Pricing Documentation

### OECD/G20 Transfer Pricing Documentation Standard

C.2.2.1. The OECD first published guidance on transfer pric- ing documentation in 1995, shortly after the first individual country rules on documentation were developed. The original OECD guide- lines contained general principles but did not prescribe a list of specific items to be included in transfer pricing documentation. Over the ensu- ing 20 years, numerous countries adopted transfer pricing documen- tation rules and gained experience administering those rules. Several multinational bodies also sought to develop consistent transfer pricing documentation standards. Notwithstanding these efforts by multina- tional 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.**90**

* + - * 1. The OECD/G20 2015 guidance sets out a standard- ized three-tiered approach to transfer pricing documentation. It suggests that documentation should include: (i) a master file contain- ing general information about the MNE group relevant to all MNE group members; (ii) a local file referring specifically to material trans- actions of the MNE group 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

90 OECD (2015), *Transfer Pricing Documentation and Country-by- Country Reporting, Action 13 —2015 Final Report,* OECD/G20 Base Ero- sion and Profit Shifting Project, OECD Publishing, Paris. [*http://dx.doi.*](http://dx.doi.org/10.1787/9789264241480-en)[*org/10.1787/9789264241480-en*](http://dx.doi.org/10.1787/9789264241480-en)(hereafter “OECD/ G20 Final Documenta- tion Report).

Report”) containing certain information relating to the global allo- cation among taxing jurisdictions of the MNE group’s income and taxes paid, together with certain general indicators of the location of economic activity within the MNE group. The Final BEPS Report 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.

* + - * 1. 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:

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:

1. important drivers of business profit;
2. 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 ser- vices amounting to more than 5% of group turnover;
3. a list and brief description of important service arrange- ments between members of the MNE group, 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 ser- vice costs and determining prices for intragroup services;
4. a description of the main geographic markets for the group’s products and services referred to in (b), above;
5. a brief written functional analysis describing the principal contributions to value creation by individual entities within the group; and
6. a description of important business restructuring transac- tions, acquisitions, and divestitures occurring during the fiscal year.

A description of the MNE’s intangibles, including:

1. a general description of the MNE’s overall strategy for the development, ownership and exploitation of intangibles,

including location of principal R&D facilities and location of R&D management;

1. a list of intangibles of the MNE group that are important for transfer pricing purposes and which entities own them;
2. a list of important agreements among identified associated enterprises related to intangibles, including cost contribu- tion agreements, principal R&D service arrangements, and licence arrangements;
3. a general description of the group’s transfer pricing policies related to R&D and intangibles; and
4. a general description of transfers of interests in intangibles among associated enterprises during the fiscal year, includ- ing the entities, countries and compensation involved.

A description of the MNE’s intercompany financial arrange- ments, including:

1. a general description of how the group is financed, including important financing arrangements with unrelated lenders;
2. the identification of any members of the MNE group that provide a central financing function for the group, includ- ing the country under whose laws each entity is organized and its place of effective management; and
3. a general description of the MNE’s transfer pricing poli- cies related to financing arrangements between associated enterprises.

The MNE’s annual consolidated financial statement for the fiscal year if otherwise prepared for financial reporting, regula- tory, internal management, tax or other purposes.

A list and brief description of the MNE group’s existing unilat- eral advance pricing agreements and other tax rulings relating to the allocation of income among countries.

* + - * 1. 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 Group that operate in the local country, including: (a) A description of the management structure of the local entity, a local organiza- tion 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 expla- nation of aspects affecting the local entity; and (c) A description of key competitors of the local entity.

Information related to material controlled transactions involv- ing the local entity, including:

1. a description of the transaction and the context in which it takes place;
2. the amount of intercompany payments or receipts for each category of controlled transactions involving the local entity, broken down by tax jurisdiction of the foreign payor or recipient;
3. identification of the associated enterprises involved in each category of controlled transaction and how they are related;
4. copies of all material agreements concluded by the local entity;
5. a detailed comparability and functional analysis of the tax- payer and the relevant associated enterprises with respect to each documented category of controlled transactions including changes from prior years;
6. an indication of the most appropriate transfer pricing method with regard to the category of transaction and the reasons for selecting that method;
7. an indication of which associated enterprise is selected as the tested party, if applicable, with an explanation;
8. a summary of the important assumptions made in applying the transfer pricing methodology;
9. an explanation of the reasons for using a multi-year analy- sis if relevant;
10. 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;
11. a description of any comparability adjustments performed;
12. 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;
13. a summary of the financial information used in applying the transfer pricing methodology; and
14. a copy of existing unilateral and bilateral / multilateral APAs and other tax rulings to which the local tax jurisdic- tion is not a party and which are related to the controlled transactions being analyzed.

Relevant financial information, including:

1. annual local entity financial accounts for the year concerned;
2. information and allocation schedules showing how the financial data used in the transfer pricing analysis may be tied to the annual financial statements; and
3. summary schedules of relevant financial data for compara- bles used in the analysis and the sources from which that information was derived.
   * + - 1. 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 con- stituent entity if different from the jurisdiction of residence; and

the main business activities for each constituent entity of the MNE group.

* + - * 1. In addition to prescribing standardized content for the master file, local file and the CbC Report, the OECD/G20 BEPS guid- ance addresses several important implementation issues.**91**

it is recommended in the BEPS Report that the master file and local file elements of the documentation package be imple- mented through local country legislation or administrative pro- cedures, 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 BEPS Report that the CbC Report be filed with the jurisdiction of the parent company of the MNE Group 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 TIEAs. It is rec- ognized, 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

91 See OECD/G20 Final Documentation Report, Annex IV.

for enforcing backup local filing rules in situations where MNE group 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 imple- ment 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 for joining the Multilateral Convention;

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 disclo- sure of confidential information contained in the CbC Report or other elements of the transfer pricing documentation package, including adopting appropriate legal measures to protect con- fidentiality. Protection of confidentiality is one of the principal reasons that countries agreed to use treaty exchange mecha- nisms 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 anal- ysis. 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 adjust- ments 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 MNE groups with annual con- solidated 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 OECD/G20 BEPS Report 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, will be reviewed again in 2020 after some experience is gained in preparing and using the CbC Report; 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.**92**

## Implementation of Global Documentation Standards in Developing Countries

* + - * 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, capabili- ties, and experience. It cannot automatically be assumed that these international guidelines should be adopted wholesale in every devel- oping 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 the international guidelines, however, all countries should also consider the great benefit of having consistent documentation rules from coun- try to country to minimize transfer pricing compliance burdens.
        2. Developing countries can assume that, in the future, MNE’s will prepare the master file and that large MNE’s 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

92 OECD (2016) Country-by-country Reporting XML Schema: User Guide for Tax Administrations and Taxpayers.

local file envisioned by the OECD/G20 guidance should be adopted without modification in the local country.

* + - * 1. 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 moderni- zation 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.
        2. Not all transactions that occur between associated enter- prises are sufficiently material to require full documentation in the local file. Individual country transfer pricing documentation require- ments 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 group in that economy, and the size and nature of local operat- ing entities, as well as the overall size and nature of the MNE group. Measures of materiality may be considered in relative terms (e.g. trans- actions not exceeding a percentage of revenue or a percentage of cost measure) or in absolute amount terms (e.g. transactions not exceed- ing 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 enter- prises from documentation requirements or that limit the extent of the documentation to be provided by such entities.
        3. 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.
        4. The CbC Report is likely to be delivered to the local juris- diction 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 BEPS Report contain model legislation and competent authority agreements that can be tailored to local coun- try needs in adopting the CbC reporting requirement.

* + - * 1. In considering the implementation of documentation rules, developing countries could decide to use a disclosure form as an alterna- tive 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 substi- tute for the local file, it should strike a balance between taxpayer effort required and its usefulness for tax authorities to make a proper assess- ment. The form should only be completed in relation to inter-company transactions of significant size. See the discussion of materiality at para.

C.2.2.3.4. above. Completing the form (supplemented by the master file and CbC Report otherwise prepared by the taxpayer) could be suffi- cient 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 produced with the tax return in every case. The compliance burden and compliance costs for MNEs may be reduced by introducing such a form, while not compromising the information 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 neigh- bouring 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.

## C .2 .3 . Experiences of Multinational Enterprises with Existing International Guidelines on Documentation

* + - 1. The documentation compliance burden has increased significantly in the last decade with more and more countries intro- ducing specific transfer pricing documentation requirements. At the

beginning of this millennium 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 coun- tries may introduce transfer pricing documentation requirements that differ significantly from country to country, resulting in a substantial increase in compliance costs for MNEs.

* + - 1. 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 harmonies rules so the preparation of documentation will not become a business in itself instead of a support to the MNEs business and global tax compliance.
      2. Currently a large number of transfer pricing reports are prepared annually just to satisfy local requirements, e.g. country-specific nuances, local language, annual searches and increas- ing 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 recom- mended that transfer pricing documentation be periodically reviewed in order to determine whether functional and economic analyzes 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 analyzes and descriptions of comparables may not change significantly from year to year. In order to simplify compliance burdens on taxpayers the tax administration may deter- mine, 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. See the OECD/G20 Final Documentation Report, paragraphs D.5.37 and D.5.38.
      3. If more consistency can be achieved with regard to 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.
      4. It is important that the documentation rules be broad enough to capture the reality of the related party transaction with- out being excessively burdensome on the mere chance that, though unlikely, a particular piece of information may be relevant.

## C .2 .4 . Practical Guidance on Documentation Rules and Procedures

* + - 1. **Burden of Proof**
         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 consult Chapter B.8.
         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 related parties falls on the taxpayer, unless the taxpayer is believed to have fulfilled the obligations imposed by such documen- tation rules. Even where the burden of proof rests on the tax adminis- tration, 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 prop- erly. 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.
         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 reasona- ble 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.
         4. Developing countries should ensure that the relation- ships 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 asser- tions that may be difficult to substantiate through an ordinary level of transfer pricing documentation. In other words, both the tax admin- istration and the taxpayer should practice good faith through reason- able documentation that their determinations on transfer pricing are consistent with the arm’s length principle regardless of where the burden of proof lies.

## Timeframe to Produce Transfer Pricing Documentation

* + - * 1. In general, countries have different timing requirements for the production of transfer pricing documentation. Any requirement that requires preparation of documentation at the time of the transac- tion, at the time the tax return is filed, or at the beginning of an audit may be referred to as a “contemporaneous” documentation require- ment. Because timing rules differ from country to country, however, the Committee refrained from using the word “contemporaneous” to describe documentation requirements in this chapter in order to avoid confusion. Countries should consider what timing requirements best suit their needs and are consistent with their administrative proce- dures. 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 sub- mitted at the time of filing the tax return;

prepare information at the time of the transactions, to be sub- mitted 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.

* + - * 1. Taxpayers, in some cases, establish transfer pricing docu- mentation to demonstrate that they have made reasonable efforts to comply with the arm’s length principle at the time their intra-group transactions were undertaken based on information that was reasona- bly 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 transac- tion. 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 Chapter B.2, Para. B.2.4 for a detailed discussion of this area. See also OECD TPG paragraphs 3.69 –3.71.

* + - * 1. A country that wishes to establish a transfer pricing docu- mentation rule should take into account the existence of the two pric- ing approaches mentioned above. Whether the arm’s length price setting or outcome-testing approach is used, data for external compa- rables may not be readily available at the time of the analysis.
        2. 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.**93** The guidance contained in the OECD/G20 Final Documentation Report suggests that the CbC Report be completed one year from the close of the MNE group’s fiscal year to which the CbC Report relates.
        3. The OECD Transfer Pricing Guidelines note that it would be quite burdensome if detailed documentation were required on

93 Ultimately issues regarding the storage of relevant documents may depend on domestic law. Most countries may require taxpayers to keep docu- mentation in paper format. However, depending on the development status of a country’s electronic technology, some countries may require the tax- payer to store the material in a [readily searchable] electronic format instead of paper format. For example, 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 TPG paragraphs 5.35 –5.36.

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 trans- fer price determinations. The local file, in particular, should be limited to material transactions. As noted above, under the OECD/G20 guid- ance, the definition of materiality is left to local law and should be specified in light of local conditions.

## Penalties

* + - * 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 documen- tation requirements.
        2. However, a number of countries also have incentive meas- ures eliminating penalties for underpayment of taxes in cases where obligations for proper documentation have been fulfilled by taxpay- ers 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”.
        3. In general, penalties can entail civil (or administrative) or criminal sanctions. Penalties imposed for failure to meet transfer pric- ing documentation requirements are usually monetary sanctions of a civil or administrative, rather than a criminal, nature. In some coun- tries, a failure of the taxpayer to comply with documentation rules may lead to greater scrutiny by the tax administration and risk assess- ment 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.
        4. It would be unfair to impose sizable penalties on taxpay- ers 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 group did not have access at the time of the documentation process, or for failure to apply a transfer pric- ing method that would have required the use of data unavailable to the MNE group. However, this does not mean that a transfer price cannot be adjusted retroactively, with interest accruing on that amount.

* + - * 1. 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 appli- cable 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 accord- ance with the relevant tax treaty.
        2. 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.
        3. 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.

## Special Considerations for Small and Medium-sized Enterprises

* + - * 1. Comprehensive documentation requirements and subse- quent penalties imposed on non-compliant taxpayers in a coun- try may place a significant burden on taxpayers, especially on small and medium-sized enterprises (SMEs) who engage in cross-border transactions with overseas related parties. A number of countries have introduced certain special considerations in their transfer pric- ing documentation rules, based on which SME taxpayers or taxpay- ers without heavy involvement in international transactions can be

exempted from the transfer pricing documentation requirements.**94** 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.

* + - * 1. The following countries have been selected as examples to demonstrate special considerations for Transfer Pricing documenta- tion in the case of SMEs:

**France**

France has issued guidance for SMEs, with the effect that the manda- tory transfer pricing documentation requirements in the legislative pro- posal will only apply to large enterprises. Thus, SMEs should only submit transfer pricing documentation upon a specific request of the French tax authorities (FTA) in the course of a tax audit. In principle, such requests may occur only under exceptional circumstances if the FTA has gathered sufficient evidence suggesting a transfer of profit to related foreign enti- ties. However small companies are also encouraged to prepare contempo- rary transfer pricing documentation.**a**

**Germany**

SMEs do not have a duty to issue Transfer Pricing documentation. However, they are obliged to provide further information and docu- ments about the foreign business transactions when requested by the tax authorities. In this case less detailed transfer pricing documentation is required.**b**

**Netherlands**

There are no specific rules applicable to SMEs; all enterprises are obliged to prepare and keep transfer pricing documentation. However, in prac- tice, the transfer pricing documentation obligation is applied in a flex- ible manner; small companies are often permitted to provide less detailed transfer pricing documentation as compared to large companies.

**Poland**

Enterprise size does not have an influence on transfer pricing documen- tation requirements. However the volume of the transactions does. The

94 See, for example, the analysis of existing transfer pricing simplification measures undertaken by the OECD available from [http://www.oecd.org/tax/](http://www.oecd.org/tax/transfer-pricing/50517144.pdf) [transfer-pricing/50517144.pdf](http://www.oecd.org/tax/transfer-pricing/50517144.pdf)

transfer pricing documentation requirements only apply to transactions where the annual turnover in a given tax year exceeds the equivalent of:

EUR 100,000**c**—if the value of the transaction does not exceed 20 per cent of the share capital of the company;

EUR 30,000—in the case of rendering services or sale of intangi- ble values;

EUR 50,000—in all other cases; or

EUR 20,000—for all payments made to tax haven jurisdictions.

**Spain**

There could be several types of documentation compliance burden depending on the characteristics of the parties involved. Relevant fac- tors include a turnover of 8 million Euros or more, which may trigger a requirement to provide further and more thorough information. Another factor is whether transactions are undertaken with entities or individuals based in tax haven jurisdictions.

**China**

Under the new Public Notice 2016(42) China provides certain exceptions to documentation requirements that may apply to SMEs. The exceptions depend on the portion of the documentation in question. The local file is required if one of the following thresholds is exceeded for the year:

1. 200 million RMB of related party tangible asset transfers, (ii) 100 million RMB of related party financial asset transfers; (iii) 100 million RMB of related party intangible asset transfers; or (iv) 40 million RMB of other related party transfers. The local file is not required for trans- actions subject to an effective advance pricing agreement. The master file is required if the enterprise has conducted annual related party transactions exceeding 1 billion RMB. The country by country report is required if the MNE group has annual consolidated revenue exceeding
   1. billion RMB.**d**

**Korea**

The method used and the reason for adopting that particular method to comply with the arm’s length principle must be disclosed to the tax authorities by a taxpayer in a report submitted along with the annual tax return. This is not the case, however, if the total value of cross-border transactions of goods and that of cross-border transactions of services of the taxpayer for the taxable year concerned is 5 billion KRW (Korean Won) or less and 500 million KRW or less, respectively. The above obli- gation is also exempt for the taxpayer whose inter-company transaction

volume per an overseas related party is 1 billion KRW or less for goods and 100 million KRW or less for services.**e**

**India**

Under the existing rules, all taxpayers having international transactions of INR 10 Million**f** or more with their Associated Enterprises are required to file a detailed transfer pricing study report to explain the transfer pric- ing of the said transactions. Such contemporaneous documentation helps the tax authorities in understanding the transfer pricing approach of the taxpayers. With the finalization and adoption of the G20/OECD report on Action 13 of the Base Erosion and Profit Shifting Project, India is taking steps to usher in the 3-tiered documentation regime comprising the Local File; Master File; and Country by Country Report.

**Brazil**

As a general rule, documentation relating to tax accounting (which includes Transfer Pricing documentation) must be kept with the taxpayer until the expiration of the statute of limitation for tax matters (five years). This documentation must be presented to the tax administration when the taxpayer is summoned to do so for tax auditing purposes. On the other hand, taxpayers must indicate in the tax return (electronic certified tax accounting) which transfer pricing method is used for each fiscal year, and detail the TP adjustments made. Failure to present the documenta- tion allows the tax administration to choose the TP method for tax audit- ing purposes. There are three regimes for income tax for enterprises:

* + 1. small enterprises (Simples);
    2. presumed profit regime; and,
    3. the common regime (based on actual profit).

Small enterprises are not subject to TP regulations (and companies subject to this regime cannot have an ownership relationship with for- eigners). Those that opt for the presumed profit regime are subject to TP adjustments relating to exports; however, only enterprises with annual revenue (turnover) up to BRL 78,000,000 (approx. USD 23,000,000) may opt for this system.

a A company with annual turnover or gross balance sheet assets of less than EUR 400 million, which does not belong to an economic group, is exempted from documentation requirements.

b A company with turnover in goods of less than EUR 5 million Euros or

turnover in services of less than 500,000 Euros falls into this category.

cOne Euro was worth approximately USD 1.07 as of March 2017.

d6.89 Yuan Renminbi (CNY) were worth approximately USD 1 as of March 2017.

e1,117 Korean Won (KRW) were worth USD 1 as of March 2017.

f64.82 Indian Rupees (INR) were worth approximately USD 1 as March 2017.

* + - * 1. In summary, some countries have particular legisla- tive provisions that allow exemptions from the obligation to prepare transfer pricing documentation, or for submission of documents to tax authorities at the time of filing tax returns. However, some coun- tries allow similar exceptions by an administrative measure notwith- standing the lack of any specific legislation granting such exceptions. In some countries, exemptions or mitigation of transfer pricing docu- mentation obligations are directly targeted at SMEs. However, a number of countries operate such exemption or mitigation regimes mainly targeting taxpayers whose transaction volumes with over- seas related parties are quite limited. Since many SMEs are not heav- ily involved in cross-border transactions with overseas related parties, they benefit from these exemptions in an indirect way.

## Language to be used for Transfer Pricing Documentation

* + - * 1. The OECD/G20 BEPS Report notes that a requirement to provide transfer pricing in the local language can constitute a compli- cating 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 estab- lished under local laws. Countries are encouraged in the BEPS Report to permit filing of transfer pricing documentation in commonly used languages where it will not compromise the usefulness of the docu- ments. Where tax administrations believe that translation of docu- ments is necessary they should make specific requests for translation and provide sufficient time to make such translation as comfortable a burden as possible.
        2. Many countries require taxpayers to present transfer pric- ing documentation in their own 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.**95** However, some countries such as France, Germany, Netherlands and 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 documen- tation to be provided in English.

95 Further information available from <http://www.us.kpmg.com/micro> site/taxnewsflash/tp/2011/TNFTP11\_02Egypt.html

## C .3 . AUDITS AND RISK ASSESSMENT

**C .3 .1 . Introduction to Audits and Risk Assessment**

* + - 1. As discussed in Chapter B.1, the establishment of an appropriate “arm’s length” result is not an exact science and requires judgment, based on sound knowledge, experience and skill. Owing to the complexities inherent in transfer pricing, a transfer pricing enquiry is usually complicated and can become a costly exercise both for a national tax authority and a taxpayer. It should therefore not be undertaken lightly; due consideration should be given to the possible complexities and to the amount of tax at risk.
      2. The outcome of an effective audit process has two aspects:
         * increased future compliance (which indirectly contributes to future tax revenue and protection of the tax base); and
         * increased current tax revenues (where cases are success- fully audited).
      3. Transfer pricing audits are generally time and resource intensive. An increase of “current” tax revenues resulting from such audits may refer to revenues that would be collected in a year or two. The hard work involved in a transfer pricing audit may result in signif- icant revenue adjustments that can benefit a developing country. However, such results do not come quickly and easily;—considerable resilience is required due to the complexity and uncertainty inherent in transfer pricing issues. Transfer pricing units in both the tax admin- istration and the private sector often come under significant scrutiny, as the returns from the resources devoted to developing transfer pric- ing capability tend not to be quickly achieved and are not always easily identifiable.
      4. The success of audits depends a great deal on good case selection. It is therefore important to dedicate adequate time and resources to risk assessment and subsequent case selection, alongside

the provision of appropriate resources for actual audit of a case. There are various factors that could be used to “flag” higher risk transactions and these are discussed in more detail below.

* + - 1. Materiality,**96** used in isolation, is not generally a reliable basis for risk assessment, as transactions are often over or undervalued due to transfer mis-pricing. Accordingly, where materiality is used as the primary basis for case selection, an undervalued transaction may be overlooked as it appears to be immaterial. This could be a direct result of the entities charging non-arm’s length prices.
      2. It is advisable to separate the risk assessment process for transfer pricing and thin capitalization purposes (depending on domestic legislation). Thin capitalization is generally easier to detect (particularly where a debt to equity ratio safe harbour is in place as is the case in most countries) and the auditing process may be shorter. Transfer pricing audits generally take much longer to resolve and are usually more complex.
      3. Risk assessment should be carried out at various stages of the audit subsequent to the initial risk assessment, similar to a cost/ benefit analysis, to ensure the most efficient and effective use of time and resources. This should be built into the auditing process and incor- porated into an audit programme.

## C .3 .2 . Organization and Staffing of Transfer Pricing Audits

* + - 1. **Administrative Aspects**

### Administrative features

* + - * 1. Tax administrations vary in terms of how their respective transfer pricing units are set up. The spectrum of transfer pricing work

96 Materiality is a concept often used in auditing and accounting. It denotes the significance of a stated amount, a transaction or a discrepancy to the financial accounts. In this context a small transaction by a large company may not be material to the financial accounts of that company, even if there is an error or discrepancy.

undertaken, policy regulations, geographic size, level and complex- ity of transfer pricing activity, quantum of the tax base, number of resources etc. may impact on how the transfer pricing division is struc- tured within the tax administration.

* + - * 1. The following functions are nevertheless likely to exist in most countries with a fair degree of transfer pricing experience:

audit section: transfer pricing risk assessment**97** and audits;

specialist advisory function: provision of technical guidance on audits, dispute resolution (settlements) and negotiation of advance pricing agreements (APAs) etc.;

competent authority: mutual agreement procedures; and

advance pricing arrangements (APAs).

* + - * 1. In contrast, tax administrations in other countries may only have some of the aforementioned functions depending on their stage of transfer pricing advancement and development. For exam- ple, some countries do not have an APA programme or an established transfer pricing Competent Authority section.

### Administrative models

* + - * 1. Generally, two types of structural models exist for organ- izing the transfer pricing capability; centralized and decentralized.
        2. One variation that may be considered is the establishment of specialist transfer pricing capabilities separated into functional units i.e. risk assessment, audit, MAP and APA teams. There may be overlaps in the use of expertise and resources but to a large degree each functional unit will be individually staffed.
        3. An alternative approach within the decentralized model involves creating a specialist function at the centre of the tax admin- istration to advise generalist auditors and tax inspectors on how best to conduct transfer pricing audits through the provision of technical support. It is rare for these specialists to conduct audits themselves but that can happen when issues are particularly complex or contentious.

97 In some instances, the risk assessment capability may be undertaken by a separate section distinct from the audit section.

* + - * 1. Both centralized and decentralized models can be applied at a national level or in regional centres throughout the country, are interchangeable and contain their own advantages and disadvantages. There is no established best practice and tax administrations should decide which option suits their needs. It may be advisable for develop- ing countries to adopt a centralized model at the inception or during the infancy of the transfer pricing administration. This will enhance development of experience and capability, consistency and quality in audit approach and establishment of best practice. See Chapter C.5. and following for further analysis of the centralized and decentral- ized models.

## Staffing and Resourcing

* + - * 1. Transfer pricing is not an exact science and requires judgement and discretion; audits are often complex and time intensive. Owing to this, it is critical that adequate resourcing is available for such audits. Developing countries are generally more constrained in transfer pricing resources, and a tax administration can be challenged by the complexity and volume of audits. The matching of adequate and appropriate skills and resources to a transfer pricing audit is neverthe- less critical to the efficient, timely and successful conclusion and even resolution of an audit.
        2. The challenge most developing countries face is the ability to employ, develop and retain these resources. In this regard, develop- ing countries need to be innovative and strategic. Implementation of targeted recruitment and structured training programmes will assist developing countries in attracting, developing and retaining trans- fer pricing skills. Training and development including challenge and variety in work scope within the public sector is also often an attrac- tive aspect of government work and tax administrations in developing countries need to leverage off this to attract and retain transfer pricing resources. See further C.5.6.1. and following paragraphs.
        3. Most tax administrations employ a variety of skills within transfer pricing units. These include economists, lawyers, account- ants, industry experts and generalists. Over time those become trans- fer pricing specialists. Where there are insufficient transfer pricing resources it is critical that any transfer pricing audit be staffed with at least one transfer pricing specialist.
        4. It is neither practical nor good governance for a trans- fer pricing audit to be conducted by a single auditor (be it a special- ist transfer pricing auditor or otherwise). Transfer pricing audits are generally conducted by teams of two or more persons with varying degrees of input from other team members. In most developed coun- tries it is customary for every transfer pricing audit team to include an economist. In other countries, the presence of an experienced trans- fer pricing specialist is essential especially if the audit is done in part- nership with the general audit section. This “mixed teaming” approach allows transfer pricing risk to be audited alongside other tax risks; it also allows greater flexibility in resource deployment and the sharing of complementary skills and experience.
        5. Another approach adopted within centralized specialist transfer pricing teams is the partnering of less experienced transfer pricing specialists with more senior and experienced specialists. This allows for transfer of skills and knowledge sharing and is an effective way of building and growing capabilities.
        6. Developing countries with transfer pricing resource constraints may consider the use of external consultants and experts. There are instances where some countries have made use of external economists and legal counsel to provide technical opinions on transfer pricing audits. Whilst not the preferred approach, especially in view of the potential costs involved, this can be a short-term solution.
        7. Developing countries may want to explore the option of staff exchange with developed countries as a way of building capa- bility and capacity. This could be a useful mechanism for develop- ing countries to expand their transfer pricing capabilities as seconded staff from other countries could be utilized to train and develop trans- fer pricing resources and provide input into audits. Moreover, staff returning from abroad could be used to train colleagues.
        8. Various international organizations such as the United Nations, World Bank/IFC Group, the International Monetary Fund, the African Tax Administration Forum (ATAF) and the OECD run training and advisory outreach programmes in the area of transfer pricing. These programmes are many and varied in content but are essentially aimed at bringing international expertise and best practice to countries in need of developing and furthering their transfer pricing regimes.

## C .3 .3 . Selection of Taxpayers for Transfer Pricing Examination: Risk Assessment

* + - 1. **Overview**
         1. Effective risk identification and assessment are important steps toward ensuring that the most appropriate cases are selected for audit. Given the resource constraints it is important for any tax admin- istration that high risk transfer pricing cases do not “slip through the tax net”. However, even the most robust risk identification and assess- ment tools and processes may not always guarantee success in audit. The reason for this is that the level of detail available at the risk assess- ment stage may not always be sufficient to draw reliable conclusions regarding the arm’s length nature of profits/prices. This will depend on functional classification (based on the risks assumed, functions performed and risks borne by each party), the methods applied, allo- cation keys selected and so forth.
         2. There are several ways in which a tax administration may conduct its risk identification and assessment, and the approach taken is largely dependent upon the type of information and data that is available and accessible. For example, exchange control authorities in some coun- tries may work hand in hand with the tax administration and sharing of information is strong whilst in other countries such interaction may be prohibited. Some countries have strong filing and documentation requirements designed to ensure that relevant and appropriate infor- mation is submitted. This is very useful in risk identification and assess- ment, as the availability of all such relevant information can enhance the quality of the risk identification and assessment process.
         3. It is important to draw a distinction here between the information related to filing a tax return and that contained in trans- fer 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) 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 ques- tions about the company’s transfer pricing policy, identification

of transactions with associated enterprises, legal contracts, invoices, valuations, identification of transfer pricing methods used, financial information etc. Chapter C.2 of this Manual addresses documentation requirements in more detail.

* + - * 1. A tax administration should ensure a balance between the cost of compliance for taxpayers and its own information needs. This is increasingly difficult given that transactions are becoming increas- ingly complex in nature. See Chapter C.2 for a more detailed in-depth analysis of transfer pricing documentation issues.
        2. A risk identification and assessment process followed by engagement with the taxpayer can at times 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 again 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.

## Categories of Risk

* + - * 1. Transfer pricing risks arise through intra-group trans- actions e.g. payments for goods, services and intangible property, provision of financial assistance and so forth. Such transactions or categories are often readily identifiable on the income statement and/ or tax return.
        2. It may be useful to try to classify the transfer pricing risks into categories in order to give added value and context to the risk identification and assessment process. Such categorization can assist risk profilers/assessors to evaluate the aggressiveness and complexity of the risk, the possible quantum at stake and the probability of success (i.e. the likelihood of an adjustment, the level and number of resources that may be required, etc.). Such classification can assist in determin- ing whether a case is worth pursuing (now or later) and whether or not the requisite resources and expertise are available.
        3. The following describes some of the more complex cate- gories of risk that are not always readily identifiable. It is by no means exhaustive and it is acknowledged that additional classes and catego- ries of risk may exist:

Category 1: Intentional profit shifting through new structures;

Category 2: Intentional profit shifting through restructuring;

Category 3: Intentional profit shifting through incorrect func- tional classification, the use of incorrect methods, allocation keys, etc.; and

Category 4: Thin capitalization.

* + - * 1. The risk classification provided here as an example assists the risk profiler/assessor in the evaluation of each of the following in potential cases:

The likelihood of detection by revenue authorities;

The possible value of the profit shifting (and therefore the poten- tial value of the risk); and

The amount of time and resources required to audit the risk (including the level of expertise required from those resources).

### Category 1: Intentional profit shifting through new structures

* + - * 1. This category includes new structures implemented by multinationals with the intention of saving taxes by shifting profits. It is assumed that the potential tax savings for groups implementing these types of structure may be significant and the tax risk is therefore assumed to be high.
        2. It is, however, difficult to detect these structures through the general risk identification and assessment process as such struc- tures are often not disclosed. The likelihood of detection is therefore often low. In such instances a tax administration’s awareness of possi- ble tax planning schemes and structures (for example, through its disclosure and filing requirements) and its own analysis of potential loopholes in the tax system may trigger further investigation. This is, however, time and resource intensive, requiring experienced staff.

### Category 2: Intentional profit shifting through restructuring

* + - * 1. This category is different from Category 1 owing to the fact that a tax saving/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. Restructurings are not readily detectable but can be identified through static profit margins (where a subsidiary has been restructured from a full risk distributor to a limited risk distributor) or through changes in VAT returns etc.

* + - * 1. In this situation the jurisdiction where the MNE is head- quartered would face issues relating to 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/entrepre- neurial” entity remaining or created as a result of the restructuring.
        2. On the other hand, the subsidiary jurisdiction/s in Category 2 would mainly be concerned about risk stripping and profit loss. 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 economically. 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

* + - * 1. MNEs may intentionally shift profits through the misclas- sification 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) gross 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 allocating service charges based on a percentage of turnover as opposed to the actual services performed thereby extracting profits through excessive service charges.
        2. It would 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 would for instance require an evaluation of profit

margins over an extended period of time 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.

* + - * 1. The likelihood of detection at the time of risk assessment with the limited information available would be moderate to low. On the other hand, the values at risk may be moderate to high (as a result of the intentional profit shifting that has occurred), but would in all probability require the involvement of experienced resources for an extended period of time to increase the likelihood of a successful audit.

### Category 4: Thin capitalization

* + - * 1. This category includes both intentional and unintentional profit shifting by MNEs through debt. In most countries, thin capital- ization is regulated through safe harbours set at predetermined levels of debt to equity. Where this is the case, the likelihood for risk profil- ers/assessors of spotting such abuse is high, as these calculations can be easily performed or even automated to flag thinly capitalized enti- ties. Even in cases where countries do not have safe harbours, they can set parameters or thresholds for risk assessment purposes.
        2. The local laws and regulations will, accordingly, 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 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 most quickly and easily rewarded by identifying amounts of tax that should be paid.

### Category 5: Unintentional profit shifting

* + - * 1. This category results from cases where mis-pricing by taxpayers occurs but was unintended. A revenue authority may disa- gree with the pricing policies applied whether it be the functional clas- sification, methods applied, etc.
        2. Where this occurs it is likely that the values could be mate- rial (in the sense of being large), but they would be less significant than in cases where an MNE is actively implementing a profit shifting scheme.

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, as would the likelihood of detection by the revenue authorities.

* + - * 1. The descriptions of the risk categories explained above are summarized on a simple matrix in Figure C.2. The likelihood of detec- tion and the potential value of the risk is represented by the two axes and categorized as high, moderate or low. The size of the “bubble” in the diagram indicates the amount of time and resources required— the bigger the “bubble”, the higher the time and resource intensity likely to be required by the audit.
        2. Where transactions seem to fall into the above categories, it is also useful to evaluate the risks as classified and explained above, within the context of whether the risk is associated with an “inbound MNE”/ ”inbound transaction” or “outbound MNE”/ “outbound trans- action”. An “inbound MNE” is an MNE which is headquartered else- where but has a subsidiary in the country where the risk assessment is being undertaken. An “outbound MNE” is the opposite i.e. a group headquartered in the country where the risk assessment is being carried out with operations elsewhere in the world.

Figure C. 3.1:

### Likelihood of Detection

LOW

MODERATE

HIGH

V A L U E

HIGH

MODERATE

LOW

Likelihood of Detection

* + - * 1. An “inbound transaction” is a transaction where the goods or services are flowing into the country where the risk assess- ment is being conducted; and vice versa for an “outbound transaction”. It is worth noting that an outbound MNE may have inbound transac- tions. When evaluating the outbound MNE, certain flags would be triggered whereas the evaluation of the inbound transactions under- taken by the outbound MNE would trigger other risk issues. These are summarized in the table below:

Table C.3.1:

**Possible “Flags” Suggesting further Investigation**

|  |  |  |
| --- | --- | --- |
| TYPE | INBOUND TRANSACTIONS/MNEs | OUTBOUND TRANSACTIONS/MNEs |
| Funding | Thin capitalization | Interest free loans |
| Interest rates | Excessive interest rates | Too low interest rates |
| Goods | * Offshore procurement/sourc- ing companies to keep profits offshore * General mis-pricing (intentional/   unintentional) | * Offshore marketing companies to keep profits offshore * General mis-pricing (intentional/ unintentional) |
| Services | * Excessive 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 | * Excessive charges * Duplicating charges through royalties over and above inflated prices | * Not charging for intangibles developed locally * Externalizing intellectual prop-   erty without reward |
| Structures | * Restructuring * New structures | * Restructuring * New structure * To avoid/minimize imputation through controlled foreign corporation * Use of offshore branches in low- tax jurisdictions with double   taxation treaties |

## Types of Approach

* + - * 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.

### Transactional approach

* + - * 1. 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. These include, for example, interest-free loans and thin capitalization. These are more easily identifiable but not necessarily easier to audit in all circumstances. For example, due to restrictions on access to information some jurisdictions may face greater difficulty in auditing service transactions whereas other jurisdictions may be able to audit these transactions with relative ease.
        2. Alternatively, the focus could be on higher risk transac- tions with a higher possible revenue yield, such as business restruc- turings, 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

* + - * 1. A revenue authority may adopt an approach under which transactions entered into with entities in previously identified tax juris- dictions 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, domestic trade flows and domestic economic policies.
        2. It may be that transactions involving related parties in juris- dictions with higher tax rates are flagged for prioritization by tax author- ities in the other jurisdiction where those jurisdictions are perceived by MNEs to have particularly aggressive transfer pricing rules or 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 juris- dictions) 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

* + - * 1. This is in essence a hybrid of the first two approaches, but could also consider factors other than the jurisdiction of the related party or parties and the type of transactions.
        2. Other factors of interest might for instance include:

the tax compliance status of the local entity or the multina- tional group to which the entity belongs, i.e. how compliant is the company/group generally or specifically as to transfer pric- ing 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 pre- sents 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 cer- tain risks and/or functions as part of the restructuring; and

companies with excessive and/or continued accounting or tax losses relative to a profitable group outside the country where the risk is being assessed.

## Sources of Information for Risk Assessment

* + - * 1. Tax authorities should work as far as possible with the infor- mation 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. The use of quantitative rather than qualitative data will assist in the automa- tion of risk assessment tools. Examples of useful information on transac- tions include the value of the following transactions of 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.

* + - * 1. Publicly available data is a useful source. This includes newspapers, websites, databases and publications such as “Who owns Whom” or databases of company financial information. Unfortunately, databases and publications in this area can be expensive, and develop- ing countries may often have to be more reliant than their colleagues in developed countries on information provided by taxpayers.
        2. Published judgements of cases heard in other countries may contain useful intelligence regarding a group’s activities, transac- tions and pricing policies. These could also provide useful guidance on structures/schemes implemented in certain industries. The analyzes 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 donor support. Comprehensive transfer pricing databases used in transfer pricing analysis also often have a searchable database of new developments.
        3. Particular attention should be paid to any notes to the financial statements on related party transactions and loans/financial assistance.
        4. Customs data, can, in some cases, be relevant to obtain- ing information on intra-group transactions. It is sometimes the case that the import price may be an indicator of the true transfer price. See Chapter B.2, Comparability, for more details on the use of Customs data for transfer pricing purposes.
        5. Information from the taxpayer’s transfer pricing docu- mentation can be very useful. Beginning in 2017 this may include a master file and country by country report if the country follows the new BEPS documentation standard. See Chapter C.2. for more infor- mation on transfer pricing documentation.

## Risk Factors

* + - * 1. Certain risk factors or “flags” can point to the need for further examination. They should not be treated as decisive in deter- mining that non-arm’s length pricing has occurred, of course— at most they point to a higher than normal likelihood of such mis-pricing. See below for some commonly agreed risk indicators; further details are available at Chapter C.5.:

consistent and continued losses;

transactions with related parties in countries with lower effec- tive/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 favoura- ble tax jurisdictions i.e. centralized sourcing or marketing com- panies 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;

material commercial relationships with related parties in juris- dictions with aggressive/strict transfer pricing rules—the cor- porate group may be more likely to set transfer prices in favour of the more aggressive jurisdiction at the cost of the less aggres- sive jurisdiction, due to the higher likelihood of intense scru- tiny in the first jurisdiction;

the same applies in the case of material commercial relation- ships with companies located in the “home” jurisdiction of the MNE or the location where the holding company is listed;

similar considerations apply where there are material commer- cial relationships with companies in jurisdictions that employ safe harbours or similar rules that do not always align to the arm’s length principle.

## The Risk Assessment Process

* + - * 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, the stage at which potential challenges are considered etc. Some tax administrations have very sophisticated processes employing computerized systems etc. whilst others may adopt a more simplified process. Ultimately the risk iden- tification and assessment process will depend on what a tax admin- istration 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 material high risk transactions are iden- tified and audited in a timely manner.

* + - * 1. 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 docu- mentation and functional analysis to confirm initial findings;

more detailed quantification of possible risks;

initial interactions with taxpayer; and

decision as to whether to proceed to audit by way of specialist reviews or committee based/panel reviews.

## Risk Assessment Tools

* + - * 1. Some of the more common risk identification and assess- ment tools include calculation templates for thin capitalization and templates for calculating key ratios relevant to transfer pricing. Such tools are relatively basic, based on quantitative information readily available to non-transfer pricing auditors. This may include, for exam- ple, information available from the tax returns and audited financial statements to assist auditors in identifying (or “flagging”) those cases with probable transfer pricing/thin capitalization risks.
        2. Where specialist transfer pricing capability and resources are limited, generalist auditors may be used to assist with risk identi- fication and assessment. In such cases these basic tools ideally do not

require generalist auditors to apply their discretion or have specific transfer pricing/thin capitalization 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.

* + - * 1. 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.

## Risk Assessment Findings

* + - * 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 proceeding (including all workings), with an effective back-up strategy.
        2. The tax administration should design templates contain- ing 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 quantum;

the jurisdictions with which the transactions occurred;

the information reviewed e.g. the financial statements, tax return etc.; and

the outcome of the risk identification and assessment process,

i.e. what was recommended and why. This would be the most critical aspect.

## C .3 .4 . Planning for a Transfer Pricing Examination

* + - 1. **Formation of the Examination Team**
         1. Where the transfer pricing unit of the tax administra- tion decides to examine transfer pricing, the examination team should ideally be comprised of:

an overall manager who 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 pri- marily relating to domestic issues;

an international examiner who is responsible for audit activities primarily relating to international issues;

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; and

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 interna- tional examiners as well as economists in analyzing transfer pricing issues.

* + - * 1. The above-mentioned persons may not always be present in one examination team and may be provided as needed depend- ing on the current state of the audit process. One person may also be able to effectively perform two or more of the above functions. It is noted that the above seven different kinds of skill groups illustrate the knowledge and expertise needed for a transfer pricing audit team.
        2. 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.
        3. Transfer pricing economists 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 argu- ments when in discussion with the taxpayer; and

preparing or assisting the preparation of a report addressing the conclusions of the team.

* + - * 1. 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 administra- tive and substantive issues. Also, the participation of the lawyer in the audit process may expedite and make more effective the preparation of the case for possible litigation.

## Supervision of Examination

* + - * 1. A key issue for a tax administration is how to ensure transfer pricing audit approaches are uniform over the whole coun- try. 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.
        2. When Japan enacted its transfer pricing tax legislation in 1986, one of the issues was how to administer the transfer pricing legislation uniformly all over the country. There were twelve regional taxation bureaus, while a single unit had to supervise the transfer pricing assessments done by these bureaus. From the outset the 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 each transfer pricing

division could issue a correction notice to adjust transfer pricing of a taxpayer. Such an approval request should be supported by an expla- nation 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.

* + - * 1. 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 control all these cases. Therefore, gradually, the supervisory power has been dele- gated to the Senior Examiner (International Taxation) at each regional taxation bureau. The Director (International Examination) now super- vises only the larger transfer pricing audit cases. It is now possible to supervise transfer pricing audits at the level of the regional taxation bureaus as the number of tax officials who share common knowledge and expertise in transfer pricing has increased considerably.

## Issues for Examination/Examination Plan

* + - * 1. It is necessary to decide what issues will be investigated in a transfer pricing examination.**98** This involves the establishment of a transfer pricing examination plan; see Paragraph C.3.5.5.1. of this Chapter for further discussion of the examination plan.

## Audit Timetable

* + - * 1. A transfer pricing audit usually takes longer than an ordi- nary tax audit because the scope of the factual matters to be investigated is much broader and the amount of time and effort needed for transfer pricing analysis is much greater. In general, the time needed would be an average of one to two years. Experience has shown that examina- tions rarely proceed in accordance with the timetables set forth in the examination plan. The main reason is that the progress of an exami- nation depends on whether the information requirements set forth in

98 Transfer pricing audits can also be described as “examination” pro- grammes, 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.

the examination plan are satisfied. Unfortunately, the required infor- mation 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.

## Information Already in Hand

* + - * 1. Tax authorities are already in possession of certain neces- sary information before starting a transfer pricing audit. These sources form important basic data for a transfer pricing audit and include:

tax returns filed;

financial statements attached to the tax returns;

certain schedules relating to transfer pricing attached to tax returns; and

statutorily required information returns.

## Information to be Collected

* + - * 1. The first 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.
        2. It should be noted that the taxpayer’s cooperation in provid- ing the required data is essential in a transfer pricing audit; in this respect it differs from ordinary tax audits. In a transfer pricing audit, the taxpayer is often asked to create data or to put data in order for the audit team. In the case of an ordinary tax audit the taxpayer has no obligation to create a document for tax examiners. Further, it is often necessary in a transfer pricing audit to create documents or to put necessary data in an orderly form to explain the business operations and to proceed to the analytical stage. Taxpayers are expected to cooperate with the audit team in providing the necessary data, and a cooperative atmosphere during transfer pricing audits is desirable and to be encouraged.
        3. The principal means for the audit team to collect the neces- sary information is the written information request. The information request is usually backed up by criminal or other penalties to be imposed in the case of failure to comply with the request. Multiple information

requests are likely to be issued by the audit team during a transfer pric- ing 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.

* + - * 1. It should be noted that a common problem is the chal- lenge in enforcing an information request which seeks a document or information not held by the taxpayer under investigation, but held by a related but legally distinct party outside the country. In the case of Japan, the Japanese taxpayer is required to make efforts to obtain the docu- ments and accounting books held by its related party outside Japan. The Japanese tax authorities have the statutory authority to impose presump- tive taxation if the requested data is not submitted by the taxpayer.
        2. The United States has more forceful means of obtain- ing 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 proce- dures 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 authori- zation, the IRS may determine the amount at issue based solely on the information available to it. Thirdly, the Third-Party Summons proce- dure 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.

## Statute of Limitations as Provided for in the Domestic Law

* + - * 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 pric- ing 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.

* + - * 1. Another aspect of the statute of limitations is the fact that in the United States a taxpayer can waive the benefit of the statute of limitations but in other countries including Japan the state of limita- tions period is fixed and the benefit cannot be waived by a taxpayer.

## Approvals and Sign-off

* + - * 1. A transfer pricing audit, once it has started, will require a considerable investment of time and effort by the examiners. It is best to require the approval and sign-off by a superior officer or the committee of transfer pricing audits before the examination starts from the viewpoint of effective use of the tax administration’s human and other resources.

## C .3 .5 . Preliminary Examination

* + - 1. **Desk Audit**
         1. As noted above, the tax authorities have certain trans- fer pricing information in their possession before a transfer pricing audit starts. 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.

* + - * 1. Comparing the taxpayer’s financial ratios to applica- ble 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.

## Understanding the Taxpayers’ Business

* + - * 1. Understanding the taxpayer’s business operations is an essential part of the transfer pricing examination. This study can be commenced before starting a transfer pricing audit or even after that time, and should include an understanding of the following:

the taxpayer’s operations;

the operations of its affiliates (domestic and foreign);

the relationship between the taxpayer and its affiliates (domes- tic and foreign);

the role each entity plays in carrying out the activities of the controlled group; and

how much control and direction the taxpayer receives from the headquarters of the group.

* + - * 1. The following may be useful sources for gaining an under- standing of the taxpayer’s business operations:

transfer pricing documentation;

annual reports;

securities reports;

books and other publications describing the taxpayer’s operations;

reports published by securities companies;

internal audit and management reports;

organization charts (the preparation of which may require the taxpayer’s cooperation);

minutes of board meetings, committee meetings and share- holders’ meetings;

policy and procedure manuals;

internal approval documents;

written inter-company pricing policies;

customs declaration documents;

sales catalogues, brochures, and pamphlets; and

e-mails, faxes and other written correspondence between the taxpayer and its affiliates.

* + - * 1. The following questions are among those which may be asked in order to understand the taxpayer’s operations:
        2. 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 controlled group developed the trade- marks and other marketing intangibles?

which members of the controlled group advertise?

which members of the controlled group created the sales tools?; and

which members of the controlled group created and maintained the list of customers?

* + - * 1. If the taxpayer is engaged in the *manufacturing* of products:

Are affiliates distributing or selling the same or similar prod- ucts to those the taxpayer manufactures?

is the taxpayer using the same or similar manufacturing intan- gibles to those its affiliates are using?

what patents and/or know-how are involved in the relevant technology?

is there a cost sharing agreement?

did affiliates or the taxpayer buy into a cost sharing agreement?

what research and development is conducted?

what members of the controlled group do research and devel- opment?; and

how are the results of research and development disseminated among members of the controlled group?

* + - * 1. As intangibles are an important aspect of the taxpayer’s business, gaining an understanding of the following *intangibles* may also be useful:

manufacturing and marketing intangibles;

domestic and foreign patents and any prosecutions involving the taxpayer;

licenses and assignments;

patent litigation involving the taxpayer;

domestic and foreign trademark registration and trademark litigation involving the taxpayer; and

copyright registrations at the patent or copyright office.

## Understanding the Industry in which the Taxpayer Operates

* + - * 1. The following procedures may be used in order to under- stand the taxpayer’s industry:

identifying the 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.

## Approval

* + - * 1. The approval of a superior officer will usually be required before embarking on a full scale transfer pricing audit of the taxpayer when the preliminary examination is completed.
        2. The approval process will need to be coordinated with the organizational model of the transfer pricing administration. See further Chapter C.5

## Audit Procedure

* + - * 1. **Audit Approach**

The examiners need to establish the transfer pricing exam- ination 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.

## Notification to Taxpayer

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 required, this is also the time to trigger the period of submission of the contemporaneous documents.

The audit is usually concerned with transfer pricing aspects only. However, an ordinary corporate income tax audit may develop into a transfer pricing audit if the examiners find it necessary to probe into transfer pricing aspects. The number of taxable years to be covered by an audit depends on the statute of limitations. If the stat- ute of limitations is six years, the taxable years to be covered may be five or six years.

The examiners will usually suggest a meeting with the taxpayer, where the examiners may discuss the schedule of the trans- fer pricing audit and certain ground rules. If the taxpayer has submit- ted certain requested documents the examiners may also discuss the contents of such documents.

## Gathering of Information

Certain information needed for the transfer pricing audit is already 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 are often required to attach to a tax return a document relating to trans- fer pricing. For instance, in Japan Schedule 17(4) to the final tax return is required to disclose certain information on the taxpayer’s transactions with its foreign related persons and it is often a useful information source for a transfer pricing audit. An English translation of this Schedule 17(4) is produced below; and

**information returns**: information returns may be required for transfer pricing purposes.

Other necessary information will 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 provided for in a country’s taxation law. Furthermore, certain countries have specific statutory provisions for requesting information regarding transfer pricing issues.

It is useful to interview the personnel of the taxpayer engaged in marketing and sales and those in the accounting and finan- cial departments. See Paragraph C.3.5.5.10.for more details.

It is often useful to visit a sales shop and a factory of the taxpayer to understand the taxpayer’s business. During the audit the audit team may want to arrange this visit with the taxpayer. See

C.3.5.5.11 for more details.

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 the taxpay- er’s shares are listed on a stock exchange), 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.

## Sources of Information

The principal information source is the taxpayer. The taxpayer’s books, records and other written documents, and its direc- tors and employees are the principal sources of information.

A former employee or director of the taxpayer may also be a source, if necessary. In this event the former employee or direc- tor may be bound by a contract with the taxpayer not to disclose any secret information. This often causes a difficult legal question as to whether the former employee is obliged to disclose the requested infor- mation to the tax authorities. This question must be resolved in light of the domestic law of the country concerned.

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 activ- ity which is of the same type or examine the accounting books and documents of that person or corporation.**99** Tax returns of a third party in the same business will also be useful sources of informa- tion. When a third party’s information is used the tax authorities are confronted with a statutory obligation of confidentiality when deal- ing with the taxpayer. This is often discussed in the context of secret comparables.

99 Japanese Special Taxation Measures Law Art. 66 – 4, Paragraph 8.

## Language

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 coun- tries is generally silent as to which side should translate the foreign language documents necessary for transfer pricing audit. If the docu- ments are voluminous the cost of translation is substantial.

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.

If a document necessary for a transfer pricing audit is written in a foreign language and cannot be understood by the exam- iners, it will generally be the party with the burden of proof that will suffer a disadvantage.

The English language may have a unique position as a foreign language in this context. In most non-English speaking coun- tries tax examiners in charge of transfer pricing taxation are trained to understand English and may be able to read documents in English.

## Types of Information to be Gathered

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 with capital relationships.

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 particu- lar services or the licensing of particular technology. It then becomes

necessary to segment revenues, expenses, gross profit and/or operat- ing 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 addi- tional work by the taxpayer, who knows the details of the profit and loss statements. The accurate review and assessment of the financial results would be impossible without segmented profit and loss statements.

Third party information required is basically comparable data. The sources of the third party information may vary depend- ing on the possibility of finding appropriate comparables. See further Chapter B.2. on Comparability Analysis.

## Points for Examination at the Initial Stage

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 follow- ing points should be taken into consideration along with the functions performed, risks assumed and assets used by the taxpayer and by the persons compared:

whether the gross and operating profit margins arising from related transactions of the taxpayer are excessively low com- pared with those of other transactions conducted by the tax- payer 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 excessively low com- pared 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 aris- ing from related transactions are relatively low compared with those of the related persons arising from the same transactions.

Prior to the calculation of arm’s length prices, examina- tions should be conducted from different viewpoints in order to deter- mine 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 transac- tions in the same business category and substantially similar to the related transactions in terms of quantity, market level and other respects;

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.

Once the transfer pricing audit starts, various aspects of arm’s length pricing will be involved and will consume a considera- ble amount of time. After the above examinations, it may be useful to pause to reflect upon the audit in general. This will occur before start- ing 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.

## Contemporaneous Documentation

Contemporaneous documentation is explained in detail in Chapter C.2. The contemporaneous documentation the taxpayer has prepared will be an important document for the examiners, and will be one of the first documents they request.

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 appli- cation 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. Incomplete or inac- curate contemporaneous documentation may provide the examiners with a “road map” for their transfer pricing audit.

## Information Request/Supplemental Information

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 other- wise required.

corporate profile brochure (including the corporate group’s history);

organizational chart (setting out the number and names of employees);

transactional structure: a business flow chart (invoicing and settlement, and actual delivery flow);

list of shops: location, size, opening times, sales revenue, staff- ing, 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 relationship structure of group companies;

basic business agreements, distribution agreements and other agreements with the related party;

corporate profile of the related party;

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 last five years;

group global consolidated profit and loss statement and ratio of taxpayer’s sales to group global sales for last five years;

segmented profit and loss statements from the related transac- tions of the related party (if the taxpayer is the purchaser) or the taxpayer (if the taxpayer is the seller) for last 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 last five years; and

top ten products in sales by category (name of product, pur- chase price and retail prices, personnel expenses, advertising expenses and sales promotion expenses) for the last five years.

As the transfer pricing examination progresses many more questions will arise in the minds of the examiners, and accord- ingly, many supplemental information requests need to be issued by the examination team. This part of the examination process tends to be necessarily lengthy.

## Request for Interviews

It is common in a transfer pricing audit for the exam- ination 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 deter- mining the functions performed by the taxpayer and related parties and determining comparability. Transfer pricing economists and the international examiners on the examination team will almost always participate in the interviews, and a lawyer will also be involved. The aspects noted below are pertinent to the taxpayer’s responses to the requests for interviews.

The examination team will choose the personnel to interview by requesting organization charts. The personnel to be inter- viewed are decided by the examination team based on mutual discus- sion of the functions of the personnel in the organization charts.

The interviewees should be made familiar with the process and should understand the procedures, purpose and impor- tance of the interview.

Interviews are usually conducted in a cooperative manner. The taxpayer may work with the examination team to agree the rules of the interview by an advance agreement, to avoid confusion. This advance agreement will make it less likely that the taxpayer’s efforts will be interpreted as attempts to manipulate the information obtained at the interview. 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.

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.

If an interview is recorded both parties should keep a copy of the record. It may be useful to have a transcription of the inter- view 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 for the signature of the interviewee. A careful review of the written summary is needed in such event.

## Request to Visit Facilities

C.3.5.5.11.1. 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 particu- lar 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.

## Secret Comparables

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 infor- mation or suggestions for further investigation. However, using such information to establish comparables will be a problem. Secret compa- rables are discussed in detail at Paragraph B.2.4.8.

The OECDTransfer Pricing Guidelinesfor Multinational Enterprises and Tax Administrations provide, at Paragraph 3.36, the following guidance, which should be considered in any application of secret comparables:

*“Tax administrators may have information available to them from examinations of other taxpayers or from other sources of information that may not be disclosed to the taxpayer. However, it would be unfair to apply a transfer pricing method on the basis of such data unless the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts.”*

## Attorney-Client Privilege and Work Product Doctrine

The attorney-client privilege and the work product doctrine are well developed in the United States and other coun- tries, although such privilege and doctrine may not be so developed in other countries. The attorney-client privilege protects communi- cations between the client and the attorney or the attorney’s agents. Where legal advice is sought from a lawyer in his capacity as such, 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.

The attorney work product doctrine protects materials prepared for trial or in anticipation of litigation by an attorney or his agent. When litigation is reasonably anticipated in relation to the trans- fer pricing examination, the due consideration of the attorney-client privilege and the work product doctrine would be important, where they are applicable.

## Comparison Chart

C.3.5.5.14.1. In the process of examination, it may be useful to prepare a comparison table of the tested party and the comparable. A simple example of a comparison table is shown below.

Table C.3. 2:

**Comparison Chart**

|  |  |  |
| --- | --- | --- |
|  | Tested Corporation | Comparable Corporation |
| Industry code |  |  |
| The last day of accounting period |  |  |
| Contents of business |  |  |
| Principal products handled |  |  |
| 1. \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_(\_\_%) |  |  |
| 2. \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_(\_\_%) |  |  |
| 3. \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_(\_\_%) |  |  |
| 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 |  |  |
|  |  |
|  |  |
|  |  |
|  |  |
|  |  |

## C .3 .6 . Narrowing of Issues: Development of Tax Authorities’ Position

* + - 1. **Refining Understanding of the Taxpayer’s Business**
         1. During the examination process the examination team needs to review information it has obtained earlier concerning the taxpayer’s business in the light of the taxpayer’s responses to the infor- mation 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 comparable transactions or companies.

## Refining Understanding of the Taxpayer’s Industry

* + - * 1. Similar efforts will be needed in refining the understand- ing of the taxpayer’s industry. The examination team will review product line financial statements for multiple years to detect unusual fluctuations or deviations from industry norms that may not result from business cycles or product life cycles.

## Refining Functions and Risk Analysis

* + - * 1. The examination team will need to understand the func- tions and risks of the taxpayer and its affiliates before attempting to determine whether particular transactions or companies are compa- rable to the taxpayer. The examiners will need to identify the func- tions that are most important in creating value in the taxpayer’s related party transactions. The examiners use information obtained in information requests and interviews to trace the flow of transac- tions through the taxpayer. They determine who performed significant functions, whether any valuable intangibles were involved and reasons for the transactional structure.
        2. The examiners will need to determine the effect of intangi- ble property on the transactions. As higher risk justifies a higher return, the examination team will determine (i) which companies within the group bear market risks (such as fluctuations in cost, demand, pric- ing, and inventory activities), foreign exchange risks (such as fluctua- tions in foreign currency exchange rates and interest rates), credit and collection risks, product liability risks and general business risks and

1. whether they receive an appropriate benefit for their contributions.
   * + - 1. The examiners analyze the economic conditions of the taxpayer’s transactions to later identify comparable transactions and companies. The taxpayer will need to participate in this area of the examination to ensure that only appropriate comparables are used. In summary, refining functional and risk analysis is important in reaching the correct results of arm’s length transactions. See further Chapters B.2 and B.3.

## Choice of Transfer Pricing Method

* + - * 1. After refining the functional and risk analysis, the exam- ination team will choose the transfer pricing method in the light of that analysis. See further Chapter B.3 on the selection of an appropri- ate method.

## Economist’s Report or Examiners’ Interim Opinion

* + - * 1. Toward the end of the examination procedure, the exam- ination team produces an economist’s report or examiner’s interim opinion; unless the examiners judge that no adjustment should be made. It is often helpful to resolve issues or agree to disagree on certain issues while the information is fresh rather than delaying the resolu- tion until the end of the examination process.
        2. The taxpayer has significant flexibility at this stage. It may refuse and disagree with the report or opinion, accept or suggest modifications.

## Draft Proposed Adjustments

* + - * 1. When the examination team considers that it sufficiently understands the transfer pricing issues and has concluded discussions with the taxpayer, it will produce the draft proposed adjustments, if any.
        2. In some countries, the proposed adjustments may be combined with the examiners’ interim report described above, depending on the circumstances.
        3. This will be the last chance for the taxpayer to determine whether or not to reach a settlement with the examination team.

## Formal Notification to Taxpayer of Proposed Adjustment

* + - * 1. Unless the taxpayer and the examination team can reach agreement, the formal notification of the proposed adjustment will be issued.
        2. In some countries, the issuance of a formal notification of proposed adjustment is statutorily required for the issuance of the adjustment order—in which event the taxpayer is given the opportu- nity to accept the notification within a stipulated time (for instance, 30 days) and/or notify any set-offs. In other countries this formal notifi- cation procedure does not exist.

## Issuance of Adjustment/Correction

* + - * 1. If the taxpayer does not accept the formal notification of proposed adjustment, a final adjustment (i.e. a notice of deficiency) will be issued. In certain countries this final notice of correction will be issued without going through the formal notice of proposed adjustment.

## Settlement Opportunities

* + - * 1. There should be the opportunity for settlement with the examination team throughout the process of the transfer pricing examination. Proper transfer pricing planning and documentation and active involvement in the examination process may facilitate a settlement with the examination team.
        2. If a settlement cannot be achieved with the examina- tion team, it may be achieved with the administrative appeals officer. Depending on the circumstances of a case, settlement may vary greatly taking into account time and other resources that may be saved by avoiding a lengthy legal dispute.
        3. Settlement processes may be explicitly provided for in the transfer pricing rules, or applied through a broader system of tax dispute settlement. The Mutual Agreement Procedure and other aspects of dispute settlement are addressed in Chapter C.4 of this Manual.

## C .3 .7 . Case Closure

C.3.7.1. 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 informa- tion 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.

## C .3 .8 . Relationship between Transfer Pricing Audits and Advance Pricing Agreements

* + - 1. The merit of Advance Pricing Agreements (APAs) is that once an APA is agreed upon the pricing in accordance with the terms of the APA will not be disturbed by a transfer pricing examination. However, there is a subtle relationship between an APA and a trans- fer pricing audit. There is a risk that information submitted to the tax authorities for the purposes of the APA may be used for the purposes of the transfer pricing audit. Also, while an APA application is being pursued a transfer pricing audit may be conducted before the APA is finalized.
      2. As an example, the following measures are taken in Japan to protect a taxpayer’s pursuit of an APA:
         * In order to ensure confidence in the APA system, documents (other than factual documents such as financial statements, capital relationship diagrams and summary statements of busi- ness) received from a taxpayer for an APA review may not be used for a tax examination;
         * While an APA is in progress a tax examination on transfer pric- ing aspects will not be conducted for the years to be covered by the APA application (including the roll-back years).

**Table C .3 .3: 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 |
| 2011 |  |  |
| 2012 |  |  |
| 2013 |  |  |
| 2014 |  |  |
| 2015 |  |  |
| 2016 |  |  |
|  | | |
| 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 |
|  |  |  |  |
|  |  |  |  |
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## C .4 . DISPUTE AVOIDANCE AND RESOLUTION

**C .4 .1 . Introduction**

* + - 1. Dispute avoidance and resolution procedures are essen- tial to the effective and efficient functioning of all tax administrations. Such procedures, if properly designed and implemented, can enable fair and expeditious resolution of differences between tax adminis- trations and taxpayers regarding interpretation and application of the relevant tax laws. They can help reduce the uncertainty, expense and delay associated with a general resort to litigation on tax matters or a failure to provide any recourse. They can also avoid integrity issues that might sometimes arise in case of an over-reliance on ad hoc (case by case) settlements. For the reasons mentioned above dispute avoid- ance and resolution procedures are of critical importance to taxpayers and access to effective procedures is therefore a key consideration for taxpayers.
      2. The goal of dispute avoidance and resolution procedures is to facilitate the efficient and equitable determination and collec- tion of tax revenues that are properly due. Ideally, this determina- tion and collection should be done in ways that minimize controversy, cost, uncertainty and delay for both tax administrations and taxpay- ers. The most efficient method of addressing disputes is to prevent them from arising. Tax administrations seeking to use their resources most efficiently should therefore probably focus in the first instance on procedures for avoiding disputes while subsequently ensuring that appropriate dispute resolution procedures are available, should they become necessary.
      3. In the cross-border context, dispute avoidance and reso- lution 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 accord- ance with the provisions of the applicable tax treaty, if any. When a tax

treaty applies both tax administrations involved in a tax dispute ought to give effect to the provisions of that tax treaty and ought to provide rules and procedures for departing from the domestic law result where necessary to resolve disputes.

## C .4 .2 . Special Considerations for Developing Countries

* + - 1. The number of Mutual Agreement Procedure (MAP) disputes worldwide has been rising rapidly according to the MAP data for OECD countries and some partner economies**100** available at the OECD website.**101**. 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 trans- fer pricing analyzes 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 adminis- trations. It is thus particularly important for developing countries that dispute avoidance and resolution procedures be designed to operate as efficiently as possible, to minimize the demand on tax administra- tion resources. 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 the tax laws and reporting requirements of many dozens of countries and may need to address any audits or disputes that may arise in any of the countries where they do business.
      2. There are various administrative procedures that could be applied to minimize transfer pricing disputes and to help resolve them when they do arise between taxpayers and their administrations, and between different tax administrations. As indicated earlier, where two

100 The partner economies referenced here are Argentina, China, Costa Rica, Latvia and South Africa according to the OECD MAP statistics. See [http://www.oecd.org/ctp/dispute/map-statistics-2006-2014.htm.](http://www.oecd.org/ctp/dispute/map-statistics-2006-2014.htm)

101 See [http://www.oecd.org/ctp/dispute/map-statistics-2006-2014.htm.](http://www.oecd.org/ctp/dispute/map-statistics-2006-2014.htm)

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 elimi- nated wherever possible, because it constitutes a potential barrier to development of international trade and stated investment flows.

* + - 1. This chapter discusses several administrative approaches to resolving disputes caused by 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 availa- ble, are appropriate, and investments that may be required to expand the available dispute resolution procedures.

## C .4 .3 . Dispute Avoidance Procedures: Domestic

* + - 1. **Legislation and Guidance**
         1. As in other areas of the 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 admin- istrations, 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 mini- mize controversy.
         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 struck various balances between the provision of general prin- ciples and detailed rules in that legislation and accompanying guid- ance. Where general principles are preferred it is often advisable, for the sake of clarity, to supplement them with examples illustrating their application.
         3. 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 through- out the world. As long as this remains the case, departures from the arm’s length principle will create an increased risk of double or unex- pected taxation, with no realistic prospect of cross-border relief. This could make the costs of doing business in the country concerned prohibitive and have the effect of discouraging 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 very broad accept- ance of the arm’s length principle internationally.

* + - * 1. 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 pric- ing that is simplified in comparison to that adopted by more devel- oped countries and recommended by the OECD 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 prin- ciple. 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 administra- tion as it addresses more complex transactions, or the approach may no longer be needed for practical reasons.
        2. The setting of legislative priorities is obviously a matter for each country to decide for itself, in view of its particular circum- stances 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.
        3. 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 success- fully challenge inter-company pricing on this basis.
        4. 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.

* + - * 1. 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 pric- ing practices to the extent possible.

## Tax Audit Practices and Domestic Tax Policies

* + - * 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. Conversely, where a tax administration has systemic integrity or confi- dentiality 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 taxpay- ers 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 C.3. of this Manual.
        2. Tax administrations may find it useful to consult the practical guides and information publications issued by tax admin- istration organizations such as the Inter-American Center of Tax Administrations (CIAT)**102** and the OECD’s Forum on Tax Administration (FTA).**103**

102 More information (in English and Spanish) available from http:// [www.ciat.org/index.php/en.html.](http://www.ciat.org/index.php/en.html) CIAT publications cover all matters relat- ed to taxation and tax administration. Information on CIAT’s e-learning programme is available from <http://www.ciat.org/index.php/en/products-> and-services/training.html

103 A list of recent OECD publications giving guidance to tax adminis- trations is available from <http://www.oecd.org/ctp/administration/List-of-> publications.pdf. The Forum on Tax Administration’s compilation covers both direct and indirect tax issues, for enterprises of all sizes and high net worth individuals, and includes practical information, recommendations and guides for tax administration staff regarding the structuring and opera-

### Advance Rulings

* + - * 1. 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. These are discussed in more detail below in the section on cross-border dispute avoidance procedures).**104** These advance determinations can often be very helpful in avoiding disputes between that taxpayer and the tax administration.
        2. 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 effi- cient for the tax administration to issue general guidance.
        3. 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. 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. While many countries have a policy of publishing rulings after removing sensitive taxpayer information, even this approach may effectively disclose the identity of the taxpayer if these taxpayers operate in smaller markets, with negative conse- quences 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 diffi- cult, or as an interim measure while adequate published guidance is being developed.

tion of tax administrations, the management of compliance risk and other issues of common interest to tax administrations.

104 Advance Pricing Agreements are discussed in paragraph

C.4.4.2.2. infra.

* + - * 1. 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.

### Cooperative Relationships

* + - * 1. 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 coun- tries (such as Nigeria) are currently testing this approach.
        2. A cooperative relationship can benefit tax administra- tions 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.
        3. From a tax administration perspective interest in a coop- erative relationship follows from the understanding that:

effective risk management requires current, relevant, and reli- able 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.

* + - * 1. From the taxpayer’s perspective a cooperative relationship may be worthwhile because it can:

provide greater certainty and predictability regarding the taxa- tion of the taxpayer’s investments, 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.

* + - * 1. A cooperative relationship initiative tends to be admin- istration resource intensive, however, and must be carefully imple- mented 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 rela- tionship initiatives efficiently so that adequate audit resources can be devoted to less compliant taxpayers.
        2. 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.

* + - * 1. 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).

### Audit Settlements

* + - * 1. Many tax administrations, both developing and devel- oped, rely heavily on case by case audit settlements to resolve disputes with taxpayers. To the extent audit settlements are based on clarifica- tions and better understandings of relevant facts, this may be an effec- tive use of limited resources. A disadvantage of audit settlements is that such an approach of dispute resolution is often not very transparent,

is not necessarily coordinated to provide similar treatment to simi- larly situated taxpayers and is therefore not always perceived as fair by stakeholders. It may also raise more integrity concerns than some other dispute settlement procedures.

* + - * 1. Developing countries seeking to reassure current and potential investors should consider developing, improving or support- ing the supplemental domestic dispute resolution procedures discussed below, in addition to cross-border procedures where possible.

## Formal Domestic Dispute Resolution Procedures

### Administrative Appeals

* + - * 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 assess- ments or by their peers.
        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 while the second (the appeal) and the third (the special appeal, which is accepted under certain condi- tions) 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.

### Mediation/Conciliation

* + - * 1. Mediation and conciliation are sometimes mentioned as potential procedures to resolve disputes. Mediation has proven successful in resolving tax disputes within some EU Member States,

e.g. The Netherlands and the United Kingdom. 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. 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 effec- tive 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 in paragraph C.4.4.1. below.

### Judicial System

* + - * 1. An independent judicial system that gives unbiased consideration to (tax) cases can do much to improve a country’s repu- tation among investors as a jurisdiction where tax disputes can be fairly resolved.
        2. However, owing to the call in the modern business world for real-time certainty regarding tax obligations the perceived bene- fit 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 judi- cial 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.

## C .4 .4 . Dispute Avoidance Procedures: Cross-Border

* + - 1. **Tax Treaty Provisions**

### Division of taxing jurisdiction

* + - * 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 elimi- nate 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 nation- ality or capital ownership and without discrimination against the conduct of business through a permanent establishment.

* + - * 1. 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.

### The mutual agreement procedure

* + - * 1. Tax treaties also provide for a Mutual Agreement Procedure (MAP); a cross-border dispute resolution procedure found at Article 25 of both the UN and OECD Model Tax Conventions. Operated by designated tax administration officials of each country who are referred to as “competent authorities”, the MAP enables tax adminis- trations 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 procedure is sepa- rate from, and additional to, domestic law remedies to resolve disputes. However, in many countries domestic law (and in particular a final court decision) can limit available solutions under MAP.
        2. These bilateral agreements may relate only to past years, or they may take the form of Advance Pricing Agreements (APAs) that provide for agreement on a transfer pricing methodology for future years (and in many cases past years as well). The MAP also applies to resolve cross-border disputes that have arisen in particular cases.
        3. The UN Commentary on Article 25 (Mutual Agreement Procedure) provides a great deal of guidance on dispute resolution through the MAP procedure, which is relevant for both transfer pric- ing and other disputes. The UN Committee of Experts 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.**105**

* + - * 1. Some tax administrations, including for example those of Canada,**106** Germany, India, Japan,**107** The Netherlands, the United States**108** and the United Kingdom,**109** as well as the Pacific Association of Tax Administrators (PATA)**110** have published detailed internal MAP procedures. These may also provide useful comparative infor- mation 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 procedures. 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.
        2. The purpose of a MAP programme is to provide an effec- tive means of reconciling differing positions of treaty partners, so that the treaty can operate as intended to avoid double taxation or

105 The Guide is available from <http://www.un.org/esa/ffd/tax/gmap/> Guide\_MAP.pdf Tax administrations may also want to refer to the OECD Manual on Effective Mutual Agreement Procedures (MEMAP) available from <http://www.oecd.org/ctp/dispute/manualoneffectivemutualagreement-> proceduresmemap.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.

106 More information available from <http://www.cra-arc.gc.ca/tx/> nnrsdnts/cmp/mp\_rprt\_2014-2015-eng.html

107 More information available from https://[www.nta.go.jp/foreign\_](http://www.nta.go.jp/foreign_) language/MAP-Report/2015.pdf

108 More information available from <http://www.irs.gov/irm/part4/> irm\_04-060-002.html

109 More information available from <http://www.hmrc.gov.uk/> international/map.htm

110 More information available from <http://www.irs.gov/pub/irs-utl/pata_> map\_guidance\_-\_final.pdf

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 implement- ing the MAP programme are able to make decisions independently of those implementing the audit programme and are free from outside influence.

* + - * 1. 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.
        2. 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 admin- istration, rather than within the Ministry of Finance or other tax policy-making function. They believe it is helpful to establish proce- dures 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 admin- istration, or to facilitate coordination by policy-makers. The impor- tance 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”.**111** 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 2017 update.

### Operational considerations

* + - * 1. Given their purpose, it is important for MAP procedures to be operated in a consistent manner rather than handling each case

111 <http://www.oecd.org/tax/beps-2015-final-reports.htm>

in an ad hoc fashion. This will provide for similar treatment of simi- larly 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 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 interpretive 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.

* + - * 1. It is also essential to implement a policy of broad access to 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 discour- age the use of MAP, including unreasonable time limitations or unilat- eral attempts to exclude selected issues from MAP. Consideration should be given to suspending the collection of disputed tax assess- ments on cases pending in 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 procedure. 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.
        2. The MAP procedure 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 treat- ment is not, or will not be, in accordance with the treaty. Alternatively, the process can be initiated because there are questions of interpreta- tion or application of the Convention or to eliminate double taxation in cases not otherwise provided for in the Convention. 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 has to be presented to the competent authority of the country where the taxpayer is resi- dent 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 MEMAP could also be consulted.

* + - * 1. 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. It is generally understood that the competent authority of the country where the primary adjustment was made that is leading to the double taxation (or taxation not in accordance with the convention), has the burden of proof towards the other compe- tent 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.
        2. If the competent authorities agree on a way to avoid double taxation and the taxpayer agrees to the suggested solution as well, a bilat- eral agreement is entered into between the two taxing authorities and

an agreement is entered into between the respective competent author- ity and taxpayer of the country where the primary adjustment was made. Careful consideration is required on how the solution is to be imple- mented; 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 domestic statute of limitation provi- sions. 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.

### Arbitration

* + - * 1. The UN Model Convention provides for an optional treaty text that allows the competent authorities to resolve the matter by way of arbitration, if no solution can be obtained within the time frame provided by the mutual agreement article. If that text is included in the treaty for the avoidance of double taxation, or agreement exists between treaty partners to resort to arbitration pursuant to that arti- cle, competent authorities that cannot find an acceptable solution for a dispute within the requisite time frame must invoke the arbitration procedures provided by the UN Model Convention or that may have been agreed to by the treaty partners otherwise.
        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 recom- mend the inclusion of mandatory arbitration provisions in bilateral tax treaties.
        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, espe- cially 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 these arbitration provisions in trea- ties has been widely supported by taxpayers as they guarantee resolution within a specified time frame and provide certainty that double taxa- tion 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 hand- ful of cases out of the many hundreds of MAP cases submitted have been taken to arbitration under agreements concluded thus far.

* + - * 1. 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 of Experts on International Cooperation in Tax Matters 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.
        2. As reflected in the 2011 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 arbi- tration by developing countries. These arguments are summarized below together with other considerations that have been identified by members of the Subcommittee on Transfer Pricing.
        3. It has been suggested that mandatory tax treaty arbitra- tion may have the following potentially negative consequences from a developing country perspective:

developing countries may feel compelled to reach agreement in the MAP in order to avoid arbitration because they cannot afford the costs and foreign exchange requirements of arbitra- tion proceedings. This is on the basis that, unlike in a court case, the parties to the dispute will pay not just for legal expenses but also for other expenses. This may include the facilities, the arbitrator, the arbitrator’s assistants, airfares, and accommoda- tion in hotels, translators and so forth. They will also often be required to pay at least the arbitrator’s fees in a foreign currency;

positive experiences of arbitration clauses helping to force an agreement may be useful in the developed country context but may be more problematical in cases where one party may have real difficulties in funding and otherwise resourcing an arbi- tral hearing;

developed countries may have better legal representation in arbitration proceedings than developing countries can afford, especially in terms of familiarity with arbitration;

it may be difficult to find arbitrators who are sufficiently famil- iar with developing countries’ concerns and issues, and even more difficult to find arbitrators that actually are from develop- ing countries;

it may be difficult to find arbitrators without ties to one side or the other or who are not advisors to taxpayers on similar issues; and

arbitration may raise sovereignty concerns, either in terms of achieving sufficient support at the political level for adding such an obligation, or in terms of whether it is constitution- ally possible to bind one’s country to the result of an arbitration procedure.

* + - * 1. Those who support the inclusion of mandatory arbitration provisions in tax treaties have argued that these provisions will have the following benefits for developing countries and can be designed in the following ways to address their concerns:

the inclusion of arbitration provisions would send a strong signal to reassure current and potential investors that the coun- try is committed to avoiding double taxation;

experience shows that the great majority of MAP cases will not go to arbitration in any event, so the costs of arbitration may not be significant, especially for countries with few MAP cases;

arbitration may well save resources overall because it should accelerate the resolution of MAP cases and provide taxpay- ers in difficult cases with a preferable alternative to litigating their issues;

there are ways of designing the arbitration procedure to minimize costs, such as adopting streamlined “last best offer”

arbitration procedures, permitting government officials who have not been involved in the case to serve as arbitrators, limit- ing the number of arbitrators and/or limiting their face-to-face meetings. Costs could also be allocated more heavily towards developed countries and could perhaps even be funded cen- trally through the United Nations, with donor (government or other) support, although no such mechanism currently exists;

if a developed country’s position is technically weak an inde- pendent arbitrator may be better able to see that this is the case than a less experienced developing country competent author- ity analyst. Therefore, arbitration may be a way of levelling the playing field for developing countries;

advocates of arbitration believe that there are sufficient quali- fied, independent arbitrators, including experts from develop- ing countries. The 2011 UN Commentary on Article 25 permits the competent authorities to ask the UN Committee of Experts on International Cooperation in Tax Matters to develop a list of persons considered qualified to serve as arbitrators, if desired; and

as currently adopted in many bilateral treaties, arbitration operates as an added step in the treaty’s MAP procedure, to resolve disputes that the competent authorities are not able to resolve within the specified period. Advocates of arbitration do not view this as raising sovereignty concerns because the MAP procedure is itself contemplated by the treaty.

### Non-Binding Dispute Resolution Procedures

* + - * 1. The UN Committee of Experts on International Cooperation in Tax Matters in October 2015 approved the forma- tion of a Subcommittee to address, consider and report back to the Committee on dispute avoidance and resolution aspects relating to the Mutual Agreement Procedure, 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 procedure under Article 25 (in either of its alternatives in the UN Model) functions as effec- tively and efficiently as possible;

other possible options for improving or supplementing the MAP procedure, including the use of non-binding forms of dis- pute 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.**112**

The Subcommittee was to focus especially on issues affecting devel- oping countries, possible means of addressing them in a practical manner, and possibilities for improving guidance and building confi- dence in dealing with the issues in this area. The Subcommittee was composed of 30 members, including developed and developing coun- tries, global finance organizations, academics, Civil Society, interna- tional organizations and the OECD. Its report to the Committee was presented at the October 2016 session (the “2016 Report”).**113**

* + - * 1. The 2016 Report reflected:

growing political and economic uncertainties, including the anticipated growth of tax controversies in all countries as the need for tax base protection and expansion continues to grow;

uncertainty concerning domestic implementation of the BEPS Action items by countries;

expected increase in availability of information on the transfer pricing practices of MNEs due to Country-by-Country report- ing and the increased use of exchange of information provisions;

the fact that developing countries are increasingly putting in place sophisticated transfer pricing legislation and creating large business units for tax base protection; and

many countries have limited or no experience with MAP pro- cesses, which may mean that such countries are potentially losing tax revenue by not entering into a bilateral or multilateral tax dispute resolution framework.

112 <http://www.un.org/esa/ffd/tax/gmap/Guide_MAP.pdf>

113 <http://www.un.org/esa/ffd/wp-content/uploads/2016/10/12STM_> CRP4\_Disputes.pdf

* + - * 1. Subcommittee discussions revealed that limited knowl- edge of MAP procedures was one of the main reasons, besides capac- ity constraints, for developing countries’ lack of engagement. This has, in some cases, led to a situation where taxpayers do not even attempt to initiate a MAP in some countries. Accordingly, it was concluded that there is a need to return to basics and define the meaning of each dispute resolution mechanism to ensure that every party to a dispute understands what is meant when talking about alternative dispute resolution (ADR). This includes the MAP, mediation, arbitration, and expert evaluation/determination. This could become an update of the UN Guide to the Mutual Agreement Procedure under Tax Treaties with a more case study oriented approach, including examples of all documents to be prepared during the MAP for illustration purposes. It could also lead to a UN handbook on dispute resolution.
        2. The work of the Subcommittee included the full range of existing procedures for resolving cross-border tax disputes, as addressed throughout this Manual (including advance rulings, cooperative compli- ance, and MAP procedures, as well as APAs discussed below). The Subcommittee also explored the possibility of expanding such processes to include mechanisms to facilitate the development of the capacity of developing countries with little experience in MAP, drawing upon expe- rience in non-tax commercial areas of dispute resolution.
        3. In exploring such potential processes, the Subcommittee noted several overarching objectives for any such procedure, including that:

it should not interfere with the need for countries to derive an appropriate level of tax revenue from economic activities con- ducted within their respective borders from their tax base;

it should not affect countries’ ability to conduct examinations and make assessments based on the application of internation- ally agreed standards for transfer pricing and other rules and principles of international tax law;

it should promote an “investment climate” in which the taxation of cross-border investments is predictable, by enhancing the effectiveness of tax treaties and reducing double taxation; and

it should provide reassurance to competent authorities partici- pating in dispute resolution that these processes are not overly

burdensome, and are efficient and fair, also taking into account the different levels of experience and the unequal capacities of countries with MAP and related procedures.

* + - * 1. During the first meeting of the Subcommittee, non-binding dispute resolution (“NBDR”) was proposed as a means of improv- ing the efficiency of the MAP, while at the same time preserving the amicable nature of MAP negotiations. NBDR could include processes, commonly used in commercial dispute resolution but needing to be adapted for use within MAP, such as:

good offices;

mediation;

conciliation;

expert evaluation;

expert determination;

arbitration (mandatory or voluntary); and

the binding or non-binding nature of each such process.

* + - * 1. The Subcommittee had an extensive discussion of the advantages and disadvantages of NBDR. A potential advantage of non-binding procedures (such as mediation or expert evaluation, or a combination of both) is that they could help balance the differ- ent experience levels between the parties to a MAP and facilitate an earlier amicable resolution of the procedure. In addition, an increas- ing number of countries, including developing countries, are looking for means of improving their tax treaty dispute resolution mecha- nisms and seeking guidance on the measures that could or should be envisaged in order to ensure a level playing field, to support the requi- site capacity-building and further the effectiveness of the MAP. NBDR could fulfil these needs. During preparation of the Report it became clear that there was no consensus among Subcommittee members regarding the terminology to be used for these and related matters.
        2. The Report offered recommendations on how to take its work forward, including:

possible updates to the UN Model Tax Convention and its Commentary;

possible updates to the UN MAP Guide; and

the possibility of preparing a UN Handbook on Dispute Avoidance and Resolution.

The Subcommittee on Dispute Resolution has continued to explore these matters.

## Other Dispute Resolution Procedures

* + - * 1. Some treaties also contain other procedural provisions, either in the treaty or in accompanying guidance agreed between the treaty partners, to ensure smooth implementation and consistent appli- cation on a bilateral basis. For example, guidance may be provided on how taxpayers may claim at source the benefits of the treaty to which they are entitled, to minimize the need for refund claims and the asso- ciated burdens on taxpayers and tax administrations. Such guidance typically has not focused on transfer pricing because many countries have historically relied heavily on the guidance provided by the OECD Transfer Pricing Guidelines. The application of multilateral guid- ance is generally preferable, where possible, for reasons of consistency. Treaty negotiators may also wish to address specific bilateral issues, or reconcile differing multilateral approaches, by providing bilateral procedural guidance where necessary.

### Advance Pricing Agreements

* + - * 1. Advance Pricing Agreement (APA) programmes may be a particularly effective tool for providing advance transfer pricing guid- ance to taxpayers and greater certainty to both tax administrations and taxpayers, both in a domestic and cross-border context. Bilateral or multilateral APA agreements are able to help taxpayers avoid double taxation in a more structured way. In many countries both the tax administration and taxpayers tend to have a strong preference for APAs over dispute resolution by way of litigation. Some of the most active advocates of APA programmes have been OECD Member States that generally favour taxation at source such as Australia, Canada, and the Republic of Korea. China began negotiating bilateral APAs several years ago and India implemented an APA programme in July 2012.
        2. APAs have been used in many cases to resolve disputes for past years as well (through so-called “roll-backs”), sometimes address- ing a total of ten or more years at one time. Where coverage of past

years is permitted, APAs can be a very effective use of resources, espe- cially for large or complex cases. It is possible to limit APAs to future years only, but that may limit the tax administration’s ability to fully leverage the resources it invests in concluding the APA.

* + - * 1. Tax administrations generally find APAs to be a more amicable process than the audit process followed by a 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 simul- taneously with both countries. Tax administrations have also found APAs to be useful tools for developing a deeper understanding of busi- ness 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.
        2. 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.
        3. Countries with little transfer pricing experience may initially prefer to limit the terms of their APAs so they can evaluate the experience more quickly and adjust their practices if desired. 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. Another possibility is that such countries may choose to negotiate APAs first on a unilateral, rather than a bilateral, basis. It should be noted, however, that a unilateral APA does not necessarily produce results that are acceptable to other countries and is, as a result, less reassuring to potential investors seeking protection from double taxation.

### Developing and operating an APA programme

* + - * 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 for that function only. This would maximize the benefits of experience and promote an attitude of cooperation and transpar- ency. 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 proceeding. Otherwise many of the benefits typically enjoyed by tax administrations in APA proceedings may be lost.
        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 primar- ily 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 administra- tions 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 expe- riences on different cases within an industrial sector or by compar- ing 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.

* + - * 1. Most tax administrations have found that an APA term of approximately five future years strikes the best balance between effi- cient use of resources and the uncertainties associated with prospec- tive agreements. The risks associated with uncertainties can be minimized by specifying certain conditions, sometimes referred to as “critical assumptions” based on which the APA will be renegotiated if necessary. It is fair to expect a renegotiation of the APA if the applica- ble law or the covered transactions change materially, but care should be taken not to impose excessively strict requirements on the contin- ued application of an APA.
        2. 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 small and medium-sized enterprises (SMEs). A 2011 OECD survey of OECD member and observer countries found that a number of coun- tries have adopted simplified measures for SMEs, small transactions and/or low value-added services and that Canada, France, Germany, Netherlands and the United States have simplified APA procedures for SMEs.**114** These programmes generally require SME taxpayers to provide less information and may also lower the application fee, if there is one.
        3. Some administrations charge taxpayers user fees for the conclusion of an APA, as a means of funding the programme. If reason- able in amount these fees have generally been accepted by taxpayers as outweighed by the advantage of the certainty provided by the APA.

114 OECD, “Multi-Country Analysis of Existing Transfer Pricing after Simplification Measures”, 10 June 2011. Available from <http://www.oecd.org/> tax/transfer-pricing/48131481.pdf

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 circum- stances where an APA cannot be concluded. The Guide to the Mutual Agreement Procedure under Tax Treaties provides for more guidance on best practices in the structuring and operation of APA programmes, and was approved by the Committee in October 2012.**115** Tax admin- istrations may also want to refer to the Manual on Effective Mutual Agreement Procedures,**116** the Guidelines for Conducting Advance Pricing Arrangements under the Mutual Agreement Procedure (MAP APAs) in the Annex to Chapter IV of the OECD Transfer Pricing Guidelines,**117** and to the work of the EU Joint Transfer Pricing Forum on dispute resolution and APAs.**118** Finally, some national tax admin- istrations, including those of Canada, India,**119** Japan, the United Kingdom**120** and the United States**121** as well as the Pacific Association of Tax Administrators (PATA)**122** have published detailed internal APA procedures. These may also provide useful comparative information.

115 The Guide is available from <http://www.un.org/esa/ffd/tax/gmap/> Guide\_MAP.pdf

116 More information available from <http://www.oecd.org/tax/dispute/> manualoneffectivemutualagreementproceduresmemap.htm

117 More information available from <http://www.oecd-ilibrary.org/> taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises- and-tax-administrations\_20769717

118 Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee on the work of the EU Joint Transfer Pricing Forum in the field of dispute avoidance and resolution procedures and on Guidelines for Advance Pricing Agreement with the EU {SEC(2007) 246} is available from https://ec.europa.eu/taxa- tion\_customs/sites/taxation/files/docs/body/sec(2007)246\_en.pdf

119 More information available from <http://www.itatonline.org/info/> index.php/cbdts-advance-pricing-agreement-guidance-with-faqs/

120 More information available from https://[www.gov.uk/hmrc-internal-](http://www.gov.uk/hmrc-internal-) manuals/international-manual/intm422010

121 More information available from <http://www.irs.gov/pub/irs-drop/> rp-06-9.pdf

122 More information available from <http://www.irs.gov/pub/irs-utl/> pata\_bapa\_guidance\_-\_final.pdf

### Joint Audits

* + - * 1. Developing countries may also want to consider partici- pating in joint audits. These are conducted by two or more tax admin- istrations together to share information, save resources and minimize or expedite the resolution of controversies. For example, the United States and the United Kingdom concluded a joint audit of a taxpayer in 2011 that took only six months to complete and produced an Advance Pricing Agreement resolving the issues for five future years as well. 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 indus- try or issues concerned. On the other hand, issues such as different languages, authority to access foreign taxpayer information and differ- ing accounting years and audit cycles may need to be addressed.

## Multilateral Approaches

### Interpretive guidance

* + - * 1. Multilateral approaches are important tools to avoid cross-border disputes on transfer pricing and the resulting risks of unrelieved double taxation.
        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 pric- ing 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.
        3. Although the provisions of Article 9 of the UN Model Convention are very similar to Article 9 of the OECD Model, the inter- pretation 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 BEPS Project. 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 prin- ciple 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 consist- ency 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 poli- cies on transfer pricing.

## C .4 .5 . Coordination of Domestic and Cross- Border Dispute Resolution Procedures

* + - 1. Each country will have its own domestic dispute resolu- tion procedures in addition to cross-border procedures. It is important that these be properly coordinated for two reasons.
         1. First, tax administrations, especially developing country administrations with limited resources, may want to minimize dupli- cation of effort by avoiding the simultaneous operation of two parallel dispute resolution processes. Most tax administrations prefer to deal with an issue either through MAP or through domestic procedures, but do not generally operate both procedures simultaneously (with the exception of certain simultaneous MAP and domestic appeals programmes).
         2. Second, notwithstanding such resource concerns, it is important to manage any duplication issues without forcing taxpay- ers 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 admin- istrative 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 objec- tion) 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 procedures 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.

* + - * 1. 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 MAP.
        2. In some countries there is a view that the tax adminis- tration, including the Competent Authority, is bound by a final deci- sion 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.
        3. The Competent Authority of one country is, of course, not obligated in any way to accept either a court decision or an administra- tive settlement of another country. Of course the Competent Authority may 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.

## C .5 . ESTABLISHING TRANSFER PRICING CAPABILITY IN DEVELOPING COUNTRIES

**C .5 .1 . Introduction**

* + - 1. This Chapter addresses issues of setting up a dedicated transfer pricing unit in the tax administration. 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 statements and the measurement of whether it has been successful will have to take into account factors widely recognized to be key features of modern tax administrations. These include factors such as:
         * the relationship between tax policy and tax administration;
         * the need to evaluate current capabilities and gaps to be filled;
         * the need for a clear vision, a mission and a culture that reflects them;
         * 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 fine tuning.
      2. These points provide a useful framework when setting up a transfer pricing unit, even though there is no “template” that will be suitable for all countries in every respect. These issues will all need consideration in the context of decisions taken at a wider policy and tax administration level.

## C .5 .2 . Relationship between Tax Policy and Tax Administration

* + - 1. The tax policy-making function generally resides with the Ministry of Finance rather than with the tax administration in most jurisdictions. The other revenue generating organs of government (e.g. the Customs Service)**123** are also separate from the tax administration in many jurisdictions. There is, however, a particular need to bridge the gap between the policy making function and the tax administration in order to implement an effective transfer pricing regime, particularly 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; and
         * the international dimension given the link to binding tax trea- ties through provisions based upon Article 9 of the UN and OECD Model Conventions, issues of potential double taxation and the interest of other countries; and the large amounts of money that may be at stake.
      2. An essential first step in improving cooperation is to review and clarify exactly what each agency’s responsibilities and functions are and the mechanisms for contact and coordination. This review should be used to examine the scope for removing duplication and overlap of functions, and for streamlining and consolidating procedures.
      3. Some factors that could improve cooperation 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 that regime and in its administration, but also that practical lessons from the administration of the regime can be used as feedback in order to fine tune policy. Examples are:

123 Customs are relevant for transfer pricing in relation to issues of valu- ation. See for example the discussion at Chapter B.2 paragraph B.2.4.7 of this Manual and World Customs Organization, *WCO Guide to Customs Valu- ation and Transfer Pricing* (2015); available at: [http://www.wcoomd.org/en/](http://www.wcoomd.org/en/topics/key-issues/revenuepackage/~/media/36DE1A4DC54B47109514FFCD0AAE6B0A.ashx) [topics/key-issues/revenuepackage/~/media/36DE1A4DC54B47109514FFCD](http://www.wcoomd.org/en/topics/key-issues/revenuepackage/~/media/36DE1A4DC54B47109514FFCD0AAE6B0A.ashx) [0AAE6B0A.ashx](http://www.wcoomd.org/en/topics/key-issues/revenuepackage/~/media/36DE1A4DC54B47109514FFCD0AAE6B0A.ashx)

h 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;

h 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

h utilizing the experience of the administration in taxpayer service, education and enforcement, and feedback from competent authorities in improving legislation or imple- menting regulations;

* + - * + cross-secondment of tax administrators and policy-makers to each other’s teams. This will help ensure that administration officials understand the policy-making process and the objec- tives of the legislation, and that policy-makers understand the practical issues of tax administration. Good tax policy must be able to be administered and good administration must have sound policy underpinnings;
        + broader governmental policies to ensure that all investment policies with a tax dimension must have the involvement of the tax administration. For example, tax administrators should be involved in discussions about tax incentive and tax holiday policies that may affect transfer pricing and other aspects of tax administration; and
        + recognition that policy-makers should not be limited in their training to the economic effects of investment; but tax policy should also be incorporated into the training. Conversely, tax officials should also recognize the importance of investment to development and the importance of, for example, seeking to avoid double taxation in accordance with applicable law.

## C .5 .3 . Assessing Current Capabilities and Gaps to be Filled

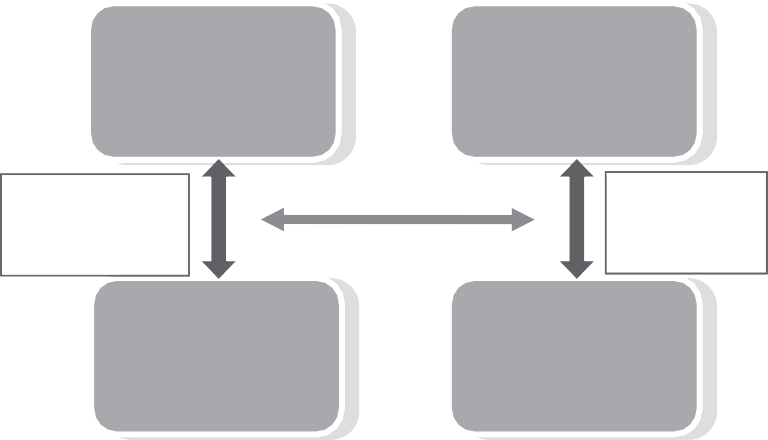
* + - 1. Different tax administrations require different types of administrative arrangements when it comes to implementing their government’s transfer pricing policies. The level of development/

capability in the tax administration should be a key factor to consider when formulating policies, which is not always the case. In many cases, there is an unrealistic expectation of an increase in capability across too many areas in too short a time.

* + - 1. In addressing the issue of developing transfer pricing capa- bility it is important, first of all, to determine the actual level of exist- ing 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, as part of a capability building plan—what is often termed a “life cycle approach”. A possible approach is outlined below in Figure C.5.1:**124**

Figure C.5.1:

### Audit Process



What the auditor must know

What the auditor must do

Knowledge Gap

Strategic Gap

What the auditor knows

What the auditor can do

124 Michael Zack, “Developing a Knowledge Strategy: Epilogue”, in *The Strategic Management of Intellectual Capital and Organizational Knowl- edge*, Nick Bontis and Chun Wei Choo, eds. (Oxford, Oxford University Press, 2002).

## Factors to consider when assessing the level of development/capability of the tax administration include:

* + - * + levels of education and expertise;
        + the legal environment or framework (as addressed in Chapter B.8) including the characteristics of the transfer pricing legisla- tion and responsibilities for and the scope of regulations – a clear and transparent legal framework is important to the function- ing of the administration as a whole,**125** and perhaps especially in a difficult and legally complex area such as transfer pricing;
        + networks of comprehensive bilateral tax treaties including arti- cles relating to Associated Enterprises (usually Article 9), the Mutual Agreement Procedure (usually Article 25) and Exchange of Information (usually Article 26). Additionally, any more lim- ited Exchange of Information agreements—especially with the countries of residence of key participants in the economy and their related parties;
        + availability of information within the country/tax adminis- tration; 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 litiga- tion where necessary, as well as those skilled in using them.

## C .5 .4 . Developing the Mission, the Vision and the Culture of the Unit

* + - 1. **Objectives**
         1. The goals of the team should be clear, both to team members and to others that they are engaging with. This includes others in the administration and stakeholders such as taxpayers and their advi- sors. Often this is put in terms of developing a “mission” representing

125 [Katherine Baer](https://www.google.com/search?tbo=p&tbm=bks&q=inauthor%3A%22Katherine%2BBaer%22&source=gbs_metadata_r&cad=4), [Olivier Benon](https://www.google.com/search?tbo=p&tbm=bks&q=inauthor%3A%22Olivier%2BBenon%22&source=gbs_metadata_r&cad=4), Juan Toro , *Improving Large Taxpayers’ Compliance: A Review of Country Experience,* ([*Volume 215 of International*](https://www.google.com/search?tbo=p&tbm=bks&q=bibliogroup%3A%22International%2BMonetary%2BFund%22&source=gbs_metadata_r&cad=4)[*Monetary Fund*](https://www.google.com/search?tbo=p&tbm=bks&q=bibliogroup%3A%22International%2BMonetary%2BFund%22&source=gbs_metadata_r&cad=4), [Occasional paper](https://www.google.com/search?tbo=p&tbm=bks&q=inauthor%3A%22Occasional%2Bpaper%22&source=gbs_metadata_r&cad=4), 2002). Available at [http://www.imf.org/](http://www.imf.org/external/pubs/nft/op/215/) [external/pubs/nft/op/215/](http://www.imf.org/external/pubs/nft/op/215/)

what the unit will do in its daily operations and a “vision” represent- ing 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 adminis- tration, and what is expected from them in the relationship.

* + - * 1. Documents reflecting the mission and the vision should become part of the culture and be “lived out” by the unit on a daily basis rather than merely being framed and put on the wall. This will be assisted by, for example, developing a team charter aligned with the wider organizational charter agreed by senior managers in the unit and key persons in the organization as a whole, preferably after conver- sations with stakeholders. This could usefully draw upon the experi- ence of other countries though it must be tailored to each country’s own realities. It is of course necessary to keep under review whether the mission and vision are being achieved in practice and, if not, why they are not being achieved.
        2. An important part of defining the unit’s objectives involves identifying, and recognizing the limitations of, 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.

## Client/Taxpayer Orientation

* + - * 1. A central consideration to be borne in mind is that a transfer pricing unit will have important taxpayer service and educa- tion functions as well as a central enforcement function. These func- tions are interrelated: better education and taxpayer service reduces the cost, resource-intensiveness 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 meas- ures on the greatest risk areas (in particular, those who have no inten- tion of complying with their obligations).
        2. Understanding the functions and environment of MNEs will most effectively and efficiently further all these service, education and enforcement activities. Handling their taxation issues will inevi- tably lead to more contacts between MNEs and the 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 nega- tive view of a country’s investment climate, deterring potential investors.

* + - * 1. On the other hand, increased focus on transfer pricing issues will inevitably lead to some disputes with MNEs and the possibil- ity of double taxation. Another country may regard more of the profits of a transaction between related parties as subject to its tax jurisdiction in accordance with a bilateral treaty; resulting in fewer profits being (in that country’s view) subject to tax in your jurisdiction. This is an increas- ingly common issue in transfer pricing and tax administrations need to devote resources to avoiding unnecessary differences. They need to ensure, where possible, that those differences do not lead to a dispute and they need to deal with formal dispute resolution procedures as expe- ditiously and effectively as possible when a dispute cannot be avoided.
        2. Most double tax treaties contain a Mutual Agreement Procedure (MAP) article to try to avoid double taxation, based upon the UN or OECD Model Tax Conventions, as noted in Chapter B.1; see also Chapter C.4, Section C.4.4. Often this is Article 25 in bilateral treaties, as it is in both Models. However, a MAP conducted between competent authorities is 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 author- ities under tax treaties and policy-makers to avoid unnecessary adjust- ments in tax assessments.
        3. Engagement with taxpayers, tax advisors and peak repre- sentative bodies is necessary to understand the transfer pricing systems of MNEs, and for the MNEs to understand what is required from them in a newly introduced transfer pricing regime. This will help, in particular, to explore shared interests such as clarity and transparency, as much certainty as possible to understand and reduce the risks of tax positions, awareness of commercial realities, fairness and consistency between taxpayers and reduced costs of compliance and collection.
        4. 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 an area where the experience of other simi- larly placed administrations is likely to be especially helpful.

* + - * 1. 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 differenti- ate non-compliance due to lack of understanding from more deliber- ate 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.
        2. 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 a con- tinuous dialogue with taxpayers, tax professionals, their asso- ciations 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 avail- able to taxpayers tax guidance notes, information circulars and other guidance on interpretation of tax laws to avoid misun- derstandings, 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 set- ting up clear and fair systems for addressing such disputes that do not unfairly deter taxpayers from pursuing legitimate grievances; and

advance rulings on specific issues of taxpayers.

* + - * 1. Steps that could be encouraged among taxpayers and their advisors include:

being transparent and open about their risks, including by making voluntary disclosures to the tax administration;

requesting and obtaining advance rulings before embarking on activities with important tax consequences, or participating in Advance Pricing Agreements where they exist;**126**

making their transfer pricing policy available to the tax administration;

recognizing the resource limitations on the side of the admin- istration and not “playing games” to tie up those resources unnecessarily to the disadvantage of the administration and other taxpayers; and

complying with the requirements of the bilateral double taxa- tion treaty between the country they are operating in and their country of residence, and understanding the circumstances when the applicability of the tax treaty to them may be denied.

## The Enforcement Approach: Risk- Based Approach to Compliance

* + - * 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:

identifying transfer pricing risks;

analyzing them (including ranking them in terms of their like- lihood and their impact if they occur); and

determining what can be done to avoid them or to limit their adverse consequences if they cannot be avoided.

The obvious risk is that the right taxpayers do not pay at the right time, but other risks, such as risks to public confidence in the system

126 The issue of whether to institute an APA programme is a complex one, which is addressed in Chapter C.4 of this Manual; see also the relevant discussion at Chapter B.8. 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.

if taxpayers are not seen as meeting their tax obligations also need to be considered.

* + - * 1. Ongoing issues of risk assessment and management are considered in more detail in Chapter C.3 of this Manual. In setting up a transfer pricing unit, however, there is an important role for offic- ers 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 devel- oped in conjunction with other areas of the administration, such as those dealing with tax treaties or thin capitalization, or those clustered around relevant industries or in offices that are differentiated based on the size of a taxpayer.
        2. As part of this risk management approach, even developed countries with long established transfer pricing regimes and adminis- trations tend in practice to have criteria that define their areas of great- est 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.**127**
        3. 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 relied on abusively so that the risk profile has changed. Examples of factors that have often been given special prominence for further investigation by administrations (without of themselves implying any mis-pricing) include situations where the local entity has:

reported losses for a number of years or more, especially if the losses start to accrue close to the time when a “tax holiday” ends;

a high value of related party transactions compared to the tax- payer’s turnover and operating profit;

significant transactions with major counterparts from low-tax or no-tax jurisdictions, non-treaty partners and countries from which information will not be readily available;

127 See for example OECD, “Multi-Country Analysis of Existing Transfer Pricing Simplification Measures”, 10 June 2011, at page 22. Available at http:// [www.oecd.org/tax/transfer-pricing/48131481.pdf](http://www.oecd.org/tax/transfer-pricing/48131481.pdf)

an economically unrealistic profit trend compared to industry trends, with no obvious explanation;

inconsistencies between inter-company contracts, transfer pricing policies and detailed transactional documents such as invoices and customs documents; or

significant royalty payments to related parties, especially if the intellectual property is not legally registered or appears to be in some part locally generated.

## C .5 .5 . Organizational Structure for the Transfer Pricing Unit

* + - 1. There are two basic types of structure 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 trans- fer pricing units by industry or geography. Each has advantages and disadvantages, as follows.

## Centralized Model

* + - * + *Advantages:* coordination and adjustments to the transfer pric- ing approach are made easier in the start-up phase; knowledge is built up quickly; the model is in tune with a centralizing ten- dency 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 oppor- tunities for mismanagement and corruption. As transfer pric- ing 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 expe- rience, 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.

## Decentralized Model

* + - * + *Advantages:* there are shorter lines of communication with tax inspectors; an easy diffusion of knowledge; combined indus- try and transfer pricing knowledge; and the model facilitates a long-term broader dissemination of transfer pricing awareness.
        + *Disadvantages:* there are risks that team members will not see their first loyalty as being to the transfer pricing unit but instead to the colleagues they most regularly work with, especially in the start-up phase of a multi-disciplinary, cross-functional team, with the danger of a lack of a single vision and coordina- tion. 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 coordina- tion by, for example, “picking and choosing” who they approach for rulings.
      1. Whatever model is followed, it is important to have a clear and coordinated approach to transfer pricing issues and their possi- ble 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 educat- ing 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.
      2. 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.

* + - 1. The benefit of a “one stop” contact point is also one reason why many administrations have Large Taxpayer Offices (LTOs), often with specific industry contact points, to handle relationships with MNEs and other large taxpayers especially in key sectors of the econ- omy such as resource extraction. These offices can respond in an inte- grated 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, includ- ing major policy or administrative reforms such as self-assessment or computer modernization of the tax office as an “incubator” for change elsewhere.
      2. In a monitoring and intelligence gathering sense, this sort of structural approach can also enable more proactive anal- ysis and action to deal quickly with emerging issues, such as unex- pected falls in revenue from key industries or segments. Such falls may merely reflect economic conditions but could, alternatively, reflect new compliance risks, such as a rise in “treaty shopping”. 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 of revenue while preserving relationships with taxpayers. This experience may also provide lessons that can be applied to the reform of the adminis- tration more generally.
      3. Many countries adopt a highly centralized model for their transfer pricing unit at start-up. This reflects the importance of coor- dination 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 struc- ture. 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 exam- ple. National coordination is then achieved by placing team members from each region on a rotation basis to work together and discuss the latest developments in transfer pricing.

* + - 1. Another model is to make all corporate income tax inspec- tors responsible for all transfer pricing cases. In that case it is sensible to appoint some regional focal points which have to be aware of all major issues and are responsible for contacting and informing policy makers.
      2. As noted above, some countries also have a separate office dealing with MNEs because of their specific characteristics, their rele- vance in terms of investment and 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, depend- ing 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 there- fore need to contain transfer pricing expertise or at the very least work especially closely with the transfer pricing unit.

## C .5 .6 . Building Team Capability

* + - 1. **General Human Resource Management Issues**
         1. A new transfer pricing regime is probably itself related to major changes within a tax administration, such as recognition of the impact of globalization and international value chains on the particu- lar country. As with most changes there are potential advantages and disadvantages. While the human resources management strategy for the unit needs to be integrated with the organization’s wider human resources strategy, 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 mutu- ally agreed and annually updated performance objectives and standards. In a new team, possibly with some reluctant but very

capable members, 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 impor- tance 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;

recognizing that not all will want to be, or be suitable as, man- agers. A strategy for recruiting and retaining technical leaders will also be necessary, as well as ensuring that their expertise is shared amongst their colleagues. 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 encour- age ways of analyzing and reaching conclusions; and

clear career prospects and incentives (such as learning opportu- nities and secondments) for successful officers, based on perfor- mance assessments that are fair and based on objective criteria reflecting the objectives 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 unjus- tified 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.

* + - * 1. 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 organ- ization do not always know exactly what it is about and feel uncertain and can be unwilling or dismissive about taking up transfer pricing issues. Further, setting up such 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 “outsid- ers” 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.
        2. The link can be established between an effective transfer pricing response and a more effective response by the organization to more general tax issues; and 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, even more importantly, 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 nego- tiation and administration. Conversely training in how particular industries operate, especially ones that are especially large in a coun- try, proportionate to other industries (such as mining, oil & gas, or telecommunications in many countries) will greatly help increase the effectiveness and focus of transfer pricing experts.**128**

128 Alexandra Readhead, *Preventing Tax Base Erosion in Africa: A Region- al Study of Transfer Pricing Challenges in the Mining Sector* (Readhead, 2016),

* + - * 1. There is, on the other hand, a risk that employees from the tax administration will become overly enthusiastic about transfer pricing as a “panacea”—a solution to all problems— and may, accord- ingly, propose unjustified or disproportionate tax adjustments leading to time consuming litigation and MAP proceedings. It is often stated that transfer pricing is not an exact science, and there is a broad range of possibilities to discuss and adjust tax returns. That inexact quality can be abused by authorities as well as by taxpayers. It is thus impor- tant 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 inex- act situation is properly exercised. This involves integrity issues and it is important that decisions taken having 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 consist- ently with the treatment of other taxpayers, but that they are also seen as doing so.

## Competences/Skill Sets Needed by the Unit: Putting Together the Best Team

* + - * 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 skillsets:

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;

Natural Resource Governance Institute, July 2016, p.26. Available at [http://](http://www.resourcegovernance.org/sites/default/files/documents/nrgi_transfer-pricing-study.pdf) [www.resourcegovernance.org/sites/default/files/documents/nrgi\_transfer-](http://www.resourcegovernance.org/sites/default/files/documents/nrgi_transfer-pricing-study.pdf) [pricing-study.pdf](http://www.resourcegovernance.org/sites/default/files/documents/nrgi_transfer-pricing-study.pdf)

business process experts (using information technology to eval- uate, automate, integrate, monitor and help improve business processes); and

those with special public relations and communication skills, including the ability to: listen actively and effectively, solve prob- lems, explain complex issues in terms that are readily under- standable 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.

* + - * 1. These various skillsets 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.**129**
        2. Dealing with MNEs demands specific characteristics and competences. Transfer pricing is about how business operates and the operation of complex, somewhat “fuzzy”, tax laws. Knowledge of inter- national taxation and good judgement 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 the opportunities to obtain information from other tax administrations and from MNEs themselves increases. Having infor- mation available but being unable to properly interpret it may put an administration in a worse position, especially before the courts, than if it never had access to the necessary information.
        3. Staff with a background in accounting have often been regarded as easy to train in transfer pricing as they are often enthusias- tic about specializing in this field, but similar enthusiasm can be found in those with other skill sets. Others, such as lawyers and economists

129 Readhead, 2016, p.24.

have special skills in dealing with the often complex law and econom- ics of transfer pricing cases, and one of the challenges in this area is having all those skills working together effectively.

* + - * 1. At the initial stages, specific transfer pricing expertise may not be generally available in the country (or at least within the admin- istration) and will in large part have to be developed. At a later stage expertise from outside may be encouraged to join the tax administra- tion by job gradings that reflect the scarcity of skills and good sala- ries – 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 and improved life- style (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.
        2. In one study the value was noted of having embedded experts seconded from other countries (sometimes the same official a few times each year) who have confronted similar problems and devel- oped pragmatic approaches to deal with them.**130** It was noted that such experts can share their experience and give auditors, for example, more confidence in demanding information from taxpayers.**131**
        3. A key challenge of working closely with taxpayers is that many of the best trained experts from the tax administration are likely to 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 effec- tive 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

130 Readhead 2016; at p. 25.

131 Readhead 2016; at p. 25.

time can be useful for each of these entities; it helps each to understand what drives the other and what the expectations are.

* + - * 1. 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 is always a range of possi- ble 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.
        2. Integrity issues may arise from the close contacts between business and the tax administration and the large amounts of money often at stake, as well as the fact that transfer pricing analysis often gives a range of results rather than a single clear answer. This can be exacerbated by a trend of many tax officials engaged in transfer pric- ing issues later moving to the private sector. The best way to deal with these issues is by having discussions with MNEs in teams, and ensur- ing that records are kept of those discussions. The records should be internally reviewable to ensure that the proper policies and prac- tices 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.
        3. 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 audi- tors into such roles can prove to be useful in this respect.
        4. 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, adherence to administration rulings, integ- rity, 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 econ- omists working on transfer pricing issues but not part of the trans- fer pricing unit— an issue discussed below) tax treaty experts and those dealing with potentially related areas, such as thin capitaliza- tion. This need for checks and balances is likely to assume even greater importance in coming years, with greater scrutiny of transfer pricing issues by civil society and parliaments likely in most countries over the coming years.**132** The role of non-government organizations in press- ing for country-by-country reporting as an outcome in the OECD/G20 BEPS project**133** is just one instance of this new reality.
        5. A well-functioning transfer pricing unit needs both legal and economic expertise and it is not purely one or the other. Transfer pricing knowledge is about pricing, economic rationale, market knowl- edge and business and industry knowledge. It is, however, also impor- tant to understand international taxation issues and the tax rationale underlying relevant transactions.
        6. 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 more broadly (as an example) are that economic issues are treated as just one aspect of the transfer pricing

132 S ee, for example, the discussion in Readhead 2016, pp. 36-38.

133 See, for example, ActionAid and other civil society organizations, “A Civil Society Agenda for the OECD” Briefing note for OECD meet- ings, January 2010, available at [http://www.taxjustice.net/cms/upload/pdf/](http://www.taxjustice.net/cms/upload/pdf/Civil_100122_soc_agenda_for_OECD.pdf) [Civil\_100122\_soc\_agenda\_for\_OECD.pdf](http://www.taxjustice.net/cms/upload/pdf/Civil_100122_soc_agenda_for_OECD.pdf)

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.

* + - * 1. 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 analyzes. Further, economists in a new area can discuss new issues and learn from each other more easily. As with any specialist skill, having economists work- ing in groups at the start-up phase may also be seen as promoting integ- rity and an “aligned” and consistent approach to the issues that arise.
        2. 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 their fellow economists in other areas, as well as other officials that will be part of multi-disciplinary transfer pricing teams.

## Training

* + - * 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 situ- ation 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.
        2. In developing what might be called a “learning plan” for the unit and its individual officers, it is recommended to first develop an assessment of the existing capabilities. This cannot be done with- out 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.
        3. This assessment should be followed by setting up a train- ing programme to operationalize its recommendations. For a start it is

good to first have a group of experts with accountancy and legal back- grounds. The pioneer group to be trained should consist of senior tax officials from the administration (and preferably also from the policy making area). They are the pioneers and champions who should instill awareness in their colleagues of the importance of a transfer pric- ing 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.

* + - * 1. Specialist courses will be an important aspect of the train- ing programme. As transfer pricing is a highly specialized exper- tise, 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 such opportunities for improving their capabilities and performance (as well as job satisfac- tion) by undertaking targeted training. International development agen- cies, regional tax administration groupings, international organizations and training institutions may be willing to assist with this. Identifying opportunities and how to most effectively request such assistance is expected to be dealt with in a future appendix to this Manual.
        2. The next step is to extend this transfer pricing knowledge and expertise to the rest of the organization. A possible model is to train several employees, who are given the appropriate level of author- ity, in each region with the right skills and make them responsible for further training as well as operational activities. However, the disad- vantage 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 policy makers to share the latest developments and discuss what is happening in other coun- tries. The policy makers will see what the major issues are and have early warning of issues on the horizon that may need swift but consid- ered policy responses.
        3. 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 need to be able to at least *identify* cases where there is a transfer pricing issue, for further consid- eration 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.
        4. 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.**134** Training in management, negotiation and inter-personal/relationship building skills will also be very important. So too will be knowledge manage- ment, 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).

## Research Materials/Databases

* + - * 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 possi- ble 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;

134 Readhead 2016; at p. 26.

materials indicating the nature of the business; and

materials indicating profit margins.

* + - * 1. 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 keep- ing a record of what is looked at, who has looked at it, and what deci- sions have been taken, 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.
        2. Private databases tend to be expensive, although some- times 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 are not avail- able for many developing countries, and the relevance of databases based on other markets and environments has to be carefully consid- ered— 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 B.2 on Comparability Analysis.
      1. 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 IMF/OECD/UN/World Bank Toolkit for Developing Countries on *Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analysis* addresses some of the issues involved in the use of databases, especially in adjusting comparables from other markets, and some of the skillsets needed.**135**

## Information Strategies

* + - * 1. The unit will need to have access to the necessary infor- mation technology hardware and software to enable them to deal with the complexity and volume of transfer pricing-related information,

135 IMF/OECD/UN/World Bank, Discussion Draft: A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyzes, 24 January 2017. Available from https://[www.oecd.org/tax/discus-](http://www.oecd.org/tax/discus-) sion-draft-a-toolkit-for-addressing-difficulties-in-accessing-comparables- data-for-transfer-pricing-analyzes.pdf

with necessary security measures in view of the commercially sensi- tive taxpayer information that will be held.

* + - * 1. 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.
        2. Some countries require material to be provided in elec- tronic 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 poten- tially 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 rele- vant legislation or regulations

## C .5 .7 . Effective and Efficient Business Processes

* + - 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 overcom- plicated 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 collec- tion costs.

* + - 1. A useful approach is to consider what other administra- tions 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.
      2. There will generally be discretions provided in the legis- lation or regulations of the transfer pricing regime in any case. Such discretions represent 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 discretions and a system of overseeing how they are exercised in practice will be needed.
      3. Owing to the amounts of money at stake in many trans- fer pricing cases, and perhaps the fact that government transfer pric- ing experts often eventually leave for the private sector, strong checks and balances are required when decisions are made affecting taxpayer liabilities to tax. On the reverse side, it needs to be clear that the unit is not anti-business, but recognizes the way business inherently oper- ates, 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.

## C .5 .8 . Application of the Above Considerations in Implementing a Transfer Pricing

**Unit and Enhancing Capability**

* + - 1. Drawing upon the factors discussed above, the start-up phase of transfer pricing operations 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 implement- ing it “on the ground” will not achieve its objective;
         * definition of the country’s industrial characteristics. It will be useful to look for statistics on trading volumes and other indi- cators for cross-border transactions. In a start-up phase many countries focus on their main industries (such as mining, phar- maceuticals, telecommunications, breweries and automobiles), and usually on the larger players in the industry in particular;
         * good, professional relations with business. Acceptance and understanding of the policy will reduce compliance and collec- tion costs. Meetings with all stakeholders will help in effectively building and improving transfer pricing policy and capabil- ity. This also means less non-compliance is likely to be due to honest misunderstandings of the regime’s requirements, and that there is more current intelligence on existing and emerg- ing 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:

h inviting representatives from other countries with a his- tory of transfer pricing to give their views and share their experiences;

h reciprocal placements with countries that offer useful expe- rience 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; and

h **s**eeking support from donors to arrange visits to such coun- tries, 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 manage- ment 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;

* + - * + An ability to define, with policy makers and administrators involved in the process, the important areas of focus bear- ing in mind:

h the main characteristics of the country’s industries, e.g. manufacturers or distribution activities;

h the main kinds of cases contained in the workload of the tax administration;

h the main types of activities to start with in developing poli- cies, recognizing the need for policy to be soundly based in reality; and

h practical case studies that can provide input for policymak- ing and a focus for discussing administration issues.

* + - 1. 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, intra-group services, etc. When a higher level of experience is reached, the focus will often shift to more complicated areas such as intangibles and business restructurings. The same jour- ney has been undertaken by developed countries. However, this does not mean that particularly blatant examples of mis-pricing in these more complicated areas should not be addressed at an early stage.

## Assessing Effectiveness and Fine Tuning

* + - * 1. It is best to set up a system of monitoring based on a performance measurement framework that establishes key perfor- mance 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 meas- urable deterrent effects on taxpayer behaviours;

the number of Mutual Agreement Procedures (MAP);

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 improve- ments 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.

* + - * 1. 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.

## C .5 .9 . Country Examples of Capacity Building in Transfer Pricing

* + - 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 manage- ment it expanded a nationwide training course for international taxa- tion 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 trans- fer pricing sections and the MAP office, while the four major regional

bureaus have special divisions for transfer pricing (including two divi- sions 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 suffi- cient language skills to conduct examinations of the original account- ing books, documents, etc. in English.

* + - 1. 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, has been conducting specialized training for officers. The Directorate has organized seminars and conferences for experience sharing by offic- ers engaged in audit and for capacity building of officers joining the Directorate.
      2. 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.
         1. 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 pric- ing cases with the assistance of the Special Audit Unit. By 2007, trans- fer pricing cases had become increasingly challenging and the Special Audit Unit had grown to twelve; 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 standard- ized approach.
         2. 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 central- izing transfer pricing activities were proposed and eventually came into force on 1 March 2009 when the unit became separated from

the Compliance Department into a full 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 pertain- ing 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.

* + - * 1. 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.

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