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Practical Manual on Transfer Pricing

for Developing Countries



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Foreword

PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES

The United Nations Practical Manual on Transfer Pricing for Developing Countries is a response to the need, often expressed by developing countries, for clearer guidance on the policy and administrative aspects of applying transfer pricing analysis to some of the transactions of multinational enterprises (MNEs) in particular. Such guidance should not only assist 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 Developed and Developing Countries¹ 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.² In this respect both Models, which between them are the basis for nearly all bilateral treaties for avoiding double taxation, endorse the “arm’s length standard” (essentially an approximation of market-based pricing) for pricing of transactions within MNEs.

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

¹United Nations, “Model Double Taxation Convention between Developed and Developing Countries”, updated 2011. Available from http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf

²OECD, “Model Tax Convention on Income and Capital”.

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

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

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

There are as yet no figures which clearly indicate the amount of revenue lost to transfer mis-pricing that might otherwise be directed to development. However, with intra-firm trade generally regarded as comprising more than 30 per cent of global trade,³ there is reason to

³See for example Alexander Yeats, “Just How Big Is Global Production Sharing?”, in *Fragmentation: New Production Pattern in the World Economy*, Sven Arndt and Henryk Kierzkowski, eds. (Oxford, Oxford University Press, 2001); Alfonso Irarrazabal, Andreas Moxnes and Luca David Opromla, “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>. The share

believe that the figures are large. While more research still needs to be done on the size of the potential losses for developing countries, and the situation will no doubt vary greatly from country to country, there is clearly great scope for pricing decisions about intra-group transactions that detrimentally impact domestic revenues for development.

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

In offering practical guidance to 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 countries, along with their capabilities, will evolve over time. A "phased" or "life cycle" approach, with a transfer pricing capability strategy identifying short, medium and longer term objectives and areas of focus will therefore often yield the best results. It follows that many developing countries may find the early history of transfer pricing in developed countries to be of special relevance, as well as the current practices in other, especially developing, countries.

By showing ways in which the "arm's length" approach to transfer pricing can operate effectively for developing countries, while giving a fair and predictable result to those investing in such countries, the Manual will also help explain why that approach has been found so

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

broadly acceptable, including in both major Model Tax Conventions. It should therefore assist countries in important decisions on how to address transfer pricing issues, whatever approach they ultimately take. It will also play a part in signposting areas where more support and assistance may be needed for countries at the various stages of their transfer pricing “journeys”.

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

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

- This is a practical Manual rather than a legislative model;
- The drafting should be as simple and clear as the subject matter permits;
- The Manual will be prepared initially in English, but with a recognition that this will not be the first language of most users. It should be translated at least into the other official United Nations languages;
- A key “value added” of the Manual is to be its practicality—addressing real issues for developing countries (and of course those dealing with the administrations of such countries) in a practical and problem-solving way. It therefore seeks to address the theory of transfer pricing, but in a way that reflects developing country realities in this area;
- The Manual, as a product of the United Nations Committee of Experts on International Cooperation in Tax Matters, has a special role in reflecting the diversity of the United Nations Membership and placing transfer pricing in its developmental perspective. This recognizes both the importance to development of fair and effective tax systems, but also the fact that foreign investment, on appropriate

terms, is seen as an important path to development by most countries;

- Helpful guidance in this complex area must, in particular, be geared to the inevitable limitations in some countries' administrations, and deficits in information and skills that many countries are affected by in this area. Issues, in particular, of building and retaining capability as well as the need for focus and efficiency in dealing with limited resources, bear strongly on the approach taken in the Manual;
- Practical examples relevant to developing countries have been especially relied upon, because the experiences of other developing countries in addressing the challenges of transfer pricing are an important way of finding effective solutions that work in their context, and of doing so in the most cost and time effective ways; and
- Consistency with the OECD Transfer Pricing Guidelines⁴ has been sought, as provided for in the Subcommittee's mandate and in accordance with the widespread reliance on those Guidelines by developing as well as developed countries.

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

⁴OECD, "Transfer Pricing Guidelines for Multinational Enterprises".

⁵Members 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.

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).

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

To assist in understanding the practical application of transfer pricing principles, this Manual frequently refers to hypothetical examples, such as in relation to Chapter 5 on Comparability Analysis and Chapter 6 on Methods. Such examples are intended to be purely illustrative, and

not to address actual fact situations or cases. Finally, it should be noted that this Manual is conceived as a living work that should be regularly revised and improved, including by the addition of new chapters and additional material of special relevance to developing countries. This will only improve its relevance to users and its significance as a work that can be relied upon in the capacity building efforts of the United Nations and others that are so needed in this field.

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Chapter 1

INTRODUCTION TO TRANSFER PRICING

1.1. What Is Transfer Pricing?

1.1.1. 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.

1.1.2. Rapid advances in technology, transportation and communication have given rise to a large number of multinational enterprises (MNEs) which have the flexibility to place their enterprises and activities anywhere in the world.

1.1.3. A significant volume of global trade nowadays consists of international 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 is growing steadily and arguably accounts for more than 30 per cent of all international transactions.

1.1.4. 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 analysing and understanding such transactions.

1.1.5. The structure of transactions within an MNE group⁶ is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. A large and growing number of international transactions are therefore no longer governed entirely by market forces, but driven by the common interests of the entities of a group.

⁶The component parts of an MNE group, such as companies, are called “associated enterprises” in the language of transfer pricing.

1.1.6. 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 prices⁷ for transactions between associated enterprises involving the transfer of property or services. These transactions 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.

1.1.7. 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 internationally applicable norms or with the arm’s length principle under domestic law, the tax administration may consider this to be “mis-pricing”, “incorrect pricing”, “unjustified pricing” or non-arm’s length pricing, and issues of tax avoidance and evasion may potentially arise. A few examples illustrate these points:

- 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.
- 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

⁷However, in most cases the transfer pricing analysis will end after an appropriate profit margin has been determined. See Chapter 6 on Transfer Pricing Methods.

scope for the parent or subsidiary, whichever is in a low-tax jurisdiction, to be shown making a higher profit by fixing the transfer price appropriately 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.

- In the next example, a high-end 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 countries 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.

1.1.8. A possible reason for associated entities charging transfer prices for intra-group trade is to measure the performance of the individual entities in a multinational group. The individual entities within a multinational group may be separate profit centres and transfer prices are required to determine the profitability of the entities. However not every entity would necessarily make a profit or loss in arm's length conditions. Rationally, an entity having a view to its own interests as a distinct legal entity would only acquire products or services from an

associated entity if the purchase price was equal to, or cheaper than, prices being charged by unrelated suppliers. This principle applies, conversely, in relation to an entity providing a product or service; it would rationally only sell products or services to an associated entity if the sale price was equal to, or higher than, prices paid by unrelated purchasers. Prices should on this basis gravitate towards the so-called “arm’s length price”, the transaction price to which two unrelated parties would agree.

1.1.9. 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 identifying and valuing intangibles transferred and/or services provided. For example, intangibles could be of various different types such as industrial 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 account. There are thus many complexities involved in dealing with transfer pricing in cross-border transactions between MNE entities.

1.1.10. Transfer pricing is a term that is also used in economics, so it is useful to see how economists define it. In business economics 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.

1.2. Basic Issues Underlying Transfer Pricing

1.2.1. 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.

1.2.2. In any cross-border tax scenario, the parties involved are the relevant entities of the MNE group along with the tax authorities 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, allocation of income and valuation.

1.2.3. 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 relevant entities' income, and if so, which one?

1.2.4. 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.

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

1.2.6. While the most obvious motivation may be to reduce the MNE's worldwide taxation, other factors may influence transfer pricing decisions, such as imputation of tax benefits in the parent company's country of residence.

1.2.7. A further motivation for an MNE to engage in such practices is to use a tax benefit, such as a tax loss, in a jurisdiction in which it operates. This may be either a current year loss or a loss that has been carried forward from a prior year by an associated company. In some cases 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 associated 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.

1.2.8. 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 optimal manner.

1.2.9. From the governments' perspective, the allocation of costs and income from the MNE's resources is an essential element in calculating the tax payable. There can thus be a dispute between countries in the allocation of costs and resources, owing to their objective of maximising the tax base in their respective jurisdictions.

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

1.2.11. 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.

1.2.12. As an MNE is an integrated structure with the ability to exploit international differentials and to utilize economies of integration not available to a stand-alone entity, transfer prices within the group are unlikely to be the same prices that unrelated parties would negotiate.

1.2.13. International tax issues, especially transfer pricing related issues, throw open a number of challenges, the complexity and magnitude of which are often especially daunting for smaller tax administrations. In short, transfer pricing rules are essential for countries in order to protect their tax base, to eliminate double taxation and to enhance cross-border trade. For developing countries, transfer pricing rules are essential to provide a climate of certainty and an environment for

increased cross-border trade while at the same time ensuring that the country is not losing out on critical tax revenue. Transfer pricing is of paramount importance and hence detailed transfer pricing rules are essential.

1.3. Evolution of Transfer Pricing

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

1.3.2. 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 domestic 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).

1.3.3. Special attention must be focused on the meaning and scope of the term “associated enterprises”, which is a topic of importance but one not defined or discussed adequately so far. This issue is discussed in more detail below.

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

1.3.5. Parent companies of large MNE groups usually have intermediary 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 structures 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 specific 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”⁸ which may operate 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.

1.3.6. 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 infrastructure, skilled labour, low production costs, conducive economic climate etc; the round-the-clock trading in financial instruments and commodities; and the rise of e-commerce and Internet-based business models are a few of the many reasons why transfer pricing has become such a high profile issue over the last couple of decades.

1.3.7. Other considerations have also had an impact on the current importance of transfer pricing. Some developed countries have tightened their transfer pricing legislation to address the issue of foreign enterprises active in their countries paying lower tax than comparable domestic groups. 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.

1.3.8. Countries with less sophisticated tax systems and administrations have run the risk of absorbing the effect of stronger enforcement 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.

1.3.9. The OECD Committee on Fiscal Affairs continues to monitor developments in transfer pricing, in particular developments in

⁸Insurance companies within a group having the specific objective of insuring group risks.

the use of profit-based methods, and in comparability matters. The OECD Guidelines have emerged out of Article 9 of the OECD Model Convention; these have also been applied in the context of the UN Model Double Tax Convention. However, developing countries have found it very difficult to implement such guidelines in practice. There are five different prescribed transfer pricing methods (see Chapter 6) 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 authorities in applying these methods may result in taxable profits between two MNEs being either more than 100 per cent or less than 100 per cent 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.

1.3.10. 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 (CCTB)” and “home state taxation”.⁹ 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 countries. Apportionment would be under an agreed formula, based upon some indicia of business activity such as some combination of sales, payroll, and assets. In recent years, the EU Joint Transfer Pricing Forum¹⁰ has developed proposals to improve transfer pricing dispute resolution (Mutual Agreement Procedure, arbitration and Advance Pricing Arrangements), and a proposal to harmonize transfer pricing documentation requirements. The proposals on EU transfer pricing 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,

⁹See, for more detail, http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm

¹⁰A committee formed by the European Commission, consisting of representatives of EU Member States and private sector representatives.

some guidelines on low-value-adding intra-group services; they are endorsed on the basis that their implementation should contribute to reducing tax disputes.

1.3.11. The United Nations for its part published an important report on “International Income Taxation and Developing Countries” in 1988.¹¹ The report discusses significant opportunities for transfer pricing manipulation by MNEs to the detriment of developing country 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 1999.¹²

1.3.12. 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.

1.4. Concepts in Transfer Pricing

1.4.1. The UN Model Tax Convention Article 9(1) states the following

“Where:

- (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for

¹¹Available from unctc.unctad.org/data/e88iia6b.pdf

¹²Available from unctad.org/en/pages/PublicationArchive.aspx?publicationid=348

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”.¹³

1.4.2. 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 9,¹⁴ with some differing interpretations as to what this means in practice. The principle laid out above in the UN Model has also been reiterated in the OECD Model Tax Convention and the OECD Guidelines as supplemented and amended.

1.4.3. Thus, the arm’s length principle is 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.

1.4.4. Under the arm’s length principle, transactions within a group are compared to transactions between unrelated entities under comparable circumstances to determine acceptable transfer prices. Thus, the marketplace comprising independent entities is the measure or benchmark for verifying the transfer prices for intra-entity or intra-group transactions and their acceptability for taxation purposes.

1.4.5. The rationale for the arm’s length principle itself is that because the market governs most of the transactions in an economy it is appropriate to treat 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 transfer prices are found to deviate from comparable arm’s length transactions. The arm’s length principle is argued to be acceptable to everyone concerned as it uses the marketplace as the norm.

¹³United Nations, New York 2011. Available from http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf

¹⁴See for example Paragraph 1 of the UN Model and OECD Model Commentaries on Article 9.

1.4.6. An argument in favour of using the arm's length principle is that it is geographically neutral, as it treats profits from investments in different places in a similar manner. However this claim of neutrality is conditional on consistent rules and administration of the arm's length principle throughout the jurisdictions in which an international enterprise operates. In the absence of consistent rules and administration, international enterprises may have an incentive to avoid taxation through transfer pricing manipulation.

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

1.4.8. A practical example follows of a situation where the arm's length principle needs to be applied:

- Assume a Corporation P (parent) manufactures automobile seats in Country A, sells the finished seats to its Subsidiary S in Country B which then sells those finished seats in Country B to unrelated parties (say, 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 sale 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.

1.4.9. Everyone, especially the tax authorities conducting transfer pricing examinations, must be acutely aware of the fact that there can be many factors affecting the arm's length price. These range from government policies and regulations to cash-flows of the entities in the MNE group.

1.4.10. There should not be an implicit assumption on the part of the tax authorities that there is profit manipulation by the MNE just because there is an adjustment to approximate the arm's length transaction; any such adjustment may arise irrespective of the contractual terms between the entities. Another incorrect assumption, often made in practice, is that the commercial or financial relations between associated enterprises and the marketplace will without fail be different and always at odds with each other.

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

1.4.12. Overall, the underlying idea behind the arm's length principle is the attempt to place transactions, both uncontrolled and controlled, on equal terms with respect to the tax advantages (or disadvantages) that they create. The arm's length principle has been widely accepted and has found its way into most transfer pricing legislation across the world.

1.4.13. 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 apportionment approach is currently used by some states of the USA, cantons of Switzerland and provinces of Canada. Also, the Brazilian transfer pricing rules¹⁵ set out a maximum ceiling on the expenses that may

¹⁵See the paper on the Brazilian approach at Chapter 10.

be deducted for tax purposes in respect of imports and lay down a minimum level for the gross income in relation to exports, effectively using a set formula to allocate income to Brazil. The EU is also considering 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

1.4.14. The process to arrive at the appropriate arm's length price typically involves the following processes or steps:

- 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.

1.4.15. The above processes are discussed in detail in Chapter 5 of this Manual on Comparability Analysis.

1.4.16. The transfer pricing methods are set forth in more detail at 1.5. below, and are dealt with comprehensively at Chapter 6. It is, however, important to note at the outset that there is no single transfer pricing method which is generally applicable to every possible situation.

1.4.17. 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.

1.5. Transfer Pricing Methods

1.5.1. 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.

1.5.2. All these transfer pricing methods rely directly or indirectly 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.

1.5.3. The five major transfer pricing methods (discussed in detail at Chapter 6 of this Manual) are as follows:

Transaction-based methods

1.5.4. 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 property or service transferred in a comparable uncontrolled transaction in comparable circumstances.

1.5.5. 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 independent 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.

1.5.6. 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 conditions and functions performed.

Profit-based methods

1.5.7. Two classes of transactional profit methods are recognized 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*.

1.5.8. 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.

1.5.9. 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.

1.5.10. 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 comparable intangible property in comparable circumstances.

1.5.11. 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 transaction. These methods are discussed in detail at Chapter 6 of this Manual.

1.6. Special Issues Related to Transfer Pricing

Documentation requirements

1.6.1. 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.

1.6.2. At every stage of the transfer pricing process, varying degrees of documentation are necessary, such as information on contemporaneous transactions. One pressing concern regarding 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 determination by the tax authorities of whether or not the taxpayer has complied with the arm's length principle. Cumbersome documentation 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).

1.6.3. Broadly, the information or documents that the taxpayer needs to provide can be classified as:

1. *enterprise-related documents* (for example the ownership/ shareholding pattern of the taxpayer, the business profile of the MNE, industry profile etc);
2. *transaction-specific documents* (for example the details of each international transaction, functional analysis of the taxpayer and associated enterprises, record of uncontrolled transactions for each international transaction etc); and
3. *computation-related documents* (for example the nature of each international 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).

1.6.4. 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 occurring in the same period of time”. Different countries have different interpretations 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 transaction, regardless of when the documentation is produced or when the comparables are obtained. Other countries interpret contemporaneous to mean using only those comparables *available* at the time the transaction occurs.

Intangibles

1.6.5. Intangibles (literally meaning assets that cannot be touched) are 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 intangibles such as trade names, trademarks and client lists that aid in the commercial exploitation of a product or service.

1.6.6. The arm's length principle often becomes difficult to apply to intangibles due to a lack of suitable comparables; for example intellectual property tends to relate to the unique characteristic of a product rather than its similarity to other products. This difficulty in finding comparables is accentuated by the fact that dealings with intangible property can also occur in many (often subtly different) ways such as by: license agreements involving payment of royalties; outright sale of the intangibles; compensation included in the price of goods (i.e., selling unfinished products including the know-how for further processing) or "package deals" consisting of some combination of the above.

1.6.7. The Profit Split Method is typically used in cases where both parties to the transaction make unique and valuable contributions. However care should be taken to identify the intangibles in question. 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.

Intra-group services

1.6.8. 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 circumstances 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.

1.6.9. 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.

1.6.10. 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.

Cost-contribution agreements

1.6.11. Cost-contribution agreements (CCAs) may be formulated 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 centralized management, advertising campaigns etc.

1.6.12. 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.

Use of “secret comparables”

1.6.13. 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 confidential 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.

1.6.14. 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.

1.6.15. Caution should be exercised in permitting the use of secret comparables in the transfer pricing audit unless the tax authorities 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 comparability or argue that adjustments are needed.

1.7. Transfer Pricing in Domestic Law

Introduction

1.7.1. Article 9 ("Associated Enterprises") of tax treaties typically 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 application — it does not create a transfer pricing regime in a country where such a regime does not already exist.

1.7.2. It should be recognized that transfer pricing regimes are creatures of domestic law and each country is required to formulate 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.

1.7.3. 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 per cent) and effective control by any other factors (dependency in financial, personnel and trading conditions). *De minimis* criteria 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 transactions to be split into apparently smaller transactions to avoid the operation of the law.

1.7.4. 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 structure of taxable persons and events but also in the manner of application 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

1.7.5. 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 administration 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.

1.7.6. 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 parameters 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 simplification benefits of a safe harbour outweigh the potential costs of applying something other than the arm's length principle.

Controlled foreign corporation provisions

1.7.7. 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 repatriated 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 taxpayer'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 pricing rules, countries can apply the CFC rules on the retained profits of foreign subsidiaries.

Thin capitalization

1.7.8. When the capital of a company is made up of a much greater contribution of debt than of equity, it is said to be “thinly capitalized”. This is because it may be sometimes more advantageous from a taxation 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 administrations 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 shifting 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

1.7.9. 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 taxpayers. 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 documentation needs to be "contemporaneous", as noted above.

1.7.10. In deciding on the requirements for such documentation there needs to be, as already noted, recognition of the compliance costs imposed on taxpayers required to produce the documentation. Another issue is whether the benefits, if any, of the documentation 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 justified because of local conditions which cannot be changed immediately (e.g. constitutional requirements or other overriding legal requirements). In other cases, there is great benefit for all in taking a widely accepted approach. See further Chapter 7 of this Manual which details the most widely accepted approaches.

Advance pricing agreements

1.7.11. Recently, multinational businesses have often depended 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 relation to certain types of transactions, often called the “covered transactions”. APAs provide greater certainty for the taxpayer on the taxation of certain cross-border transactions and are considered by the taxpayers as the safest way to avoid double taxation, especially where they are bilateral or multilateral. Many countries have introduced APA procedures in their domestic laws though having 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 implementation issues, are addressed in Chapter 9.

Time limitations

1.7.12. Another important point for transfer pricing domestic legislation is the “statute of limitation” issue—the time allowed in domestic law for the tax administration to do the transfer pricing audit and make necessary assessments or the like. Since a transfer pricing audit can place heavy burdens on the taxpayers and tax authorities, the normal “statute of limitation” for taking action is often extended compared with general domestic taxation cases. 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 may 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

1.7.13. Both developed and developing countries need to have domestic transfer pricing rules to counter transfer pricing manipulation 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 jurisdiction. The detail in such domestic laws will vary from country to country and will often vary depending on how advanced the country is in its transfer pricing journey.

1.7.14. One view is that a country's tax jurisdiction, usually some mixture of residence and source-based taxation, is based on its domestic legislation and that 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 respect a mechanism to allocate the taxing rights to prevent double taxation arising from the overlap of residence and source jurisdiction. Tax treaties 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 domestic tax for tax paid in the other treaty country. The generally held view is that under a tax treaty a tax obligation 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 respective 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 documentation required. As a consequence of these factors it is generally considered 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.

1.7.15. For transfer pricing measures to be effective, a tax 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.

1.7.16. 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.

1.8. Transfer Pricing in Treaties

UN and OECD Model Conventions: An overview

1.8.1. The OECD Model Convention¹⁶ 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 a new version produced in 2001.¹⁷ The UN Model Convention has now been further updated, and was launched as the 2011 Update on 15 March 2012. The UN Model is in many respects similar to the OECD Model but the differences (such as preserving greater taxation rights to countries hosting investments) are very significant, especially for developing countries.

1.8.2. There has historically been a widespread view that the OECD Model was most appropriate for negotiations between developed countries and less suitable for capital importing or developing

¹⁶A read-only but downloadable version of the OECD Model is available from <http://www.oecd.org/tax/treaties/oecdmtcavailableproducts.htm>

¹⁷The UN Model is available from http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf

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 provisions, 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

1.8.3. 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 independent 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 attributed to one side of the transaction, the other country should reduce the profit attributed to the other side of the transaction. The competent authorities¹⁸ of the Contracting States are if necessary to consult with each other in determining the adjustment.

1.8.4. 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.

1.8.5. 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.

¹⁸Officials designated by countries to discuss treaty and other international 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 judicial, administrative or other legal proceedings have resulted in a final ruling that, by the actions giving rise to an adjustment of profits under Article 9(1), one of the enterprises concerned is liable to a penalty with respect to fraud, or to gross or wilful default.

1.8.6. 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 enterprises 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, sometimes 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.

1.8.7. 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 9 discusses MAP in more detail.

1.8.8. Finally, there are a small number of bilateral treaties which allow for arbitration to resolve transfer pricing disputes.¹⁹ Further, the EU Arbitration Convention²⁰ establishes a procedure to resolve disputes where double taxation occurs between enterprises of different Member States in the EU as a result of an upward adjustment of profits of an enterprise of one Member State.

¹⁹A paragraph relating to arbitration has also been included in Article 25 of the OECD Model Tax Convention.

²⁰Convention 90/436/EEC 1990.

1.8.9. 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

1.8.10. Transfer pricing rules have been developed mainly within the Members of the OECD (i.e developed countries) only 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 encountering difficulties with administering the arm's length principle.

1.8.11. Developing countries often have substantial problems with the availability of comparable transactions. This issue is considered more fully in Chapter 5; it suffices to note that due to a typically 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.

1.8.12. Documentation requirements should as far as possible be common between the two Models (UN and OECD), because diversity 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).

1.9. Global Transfer Pricing Regimes

1.9.1. The UN and OECD Model Conventions, the OECD Guidelines and domestic legislation of various countries have provided examples for introduction of transfer pricing legislation worldwide, as a response to 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 Chapter 3 on the General Legal Environment.

1.9.2. By the end of 2012, there were around 100 countries with some form of specific transfer pricing legislation as shown by the light grey shading in the diagram below.

1.10. Transfer Pricing as a Current and Future Issue

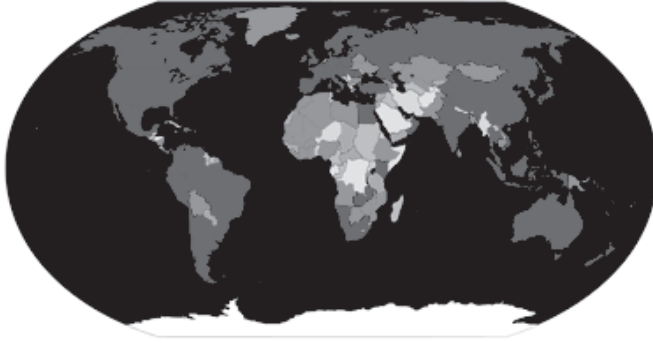
General issues with transfer pricing

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

1.10.2. Increasing globalization, sophisticated communication systems and information technology allow an MNE to control the operations of its various subsidiaries from one or two locations worldwide. 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.

1.10.3. It is widely accepted that transfer pricing is not an exact science and that the application of transfer pricing methods requires the application of information, skill and judgement by both taxpayers and tax authorities. In view of the skill, information and resource "gaps" in many developing countries, this can be very difficult for 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.

Table 1.1: Countries with Transfer Pricing Regimes and Emerging Regimes



■ **Countries with Transfer Pricing Regime**

Argentina	Australia	Austria	Belgium	Brazil
Canada	Chile	China	Colombia	Croatia
Czech Republic	Denmark	Dominican Republic	Ecuador	Egypt
Estonia	Finland	France	Germany	Hong Kong
Hungary	India	Indonesia	Ireland	Israel
Italy	Japan	Kenya	Korea, North	Korea, South
Latvia	Lithuania	Luxembourg	Malaysia	Mexico
Namibia	Netherlands	New Zealand	Norway	Oman
Panama	Peru	Philippines	Poland	Portugal
Romania	Russia	Singapore	Slovakia	Slovenia
South Africa	Spain	Sweden	Switzerland	Thailand
Turkey	United Kingdom	United States	Uruguay	Venezuela
Vietnam				

■ **Countries with Emerging Regime**

Algeria	Angola	Armenia	Aruba	Bangladesh
Belarus	Bolivia	Botswana	Bulgaria	Burkina Faso
Cambodia	Cote d'Ivoire	Cyprus	El Salvador	Ethiopia
Gambia	Georgia	Ghana	Greenland	Iceland
Kazakhstan	Kuwait	Liberia	Libya	Macedonia
Malawi	Mali	Mauritania	Mauritius	Mongolia
Morocco	Mozambique	Netherlands Antilles	Nicaragua	Nigeria
Pakistan	Papua New Guinea	Qatar	Senegal	Sierra Leone
Sri Lanka	Trinidad and Tobago	Ukraine	Uzbekistan	Zambia
Zimbabwe				

Transfer pricing and developing countries

1.10.4. 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 literally and figuratively.

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

Lack of comparables

1.10.6. One of the foundations of the arm’s length principle is examining the pricing of comparable transactions. Proper comparability is often difficult to achieve in practice, a factor which in the view of many weakens the continued validity of the principle itself. The fact is that the traditional transfer pricing methods (CUP, RPM, 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:

1. There tend to be fewer organized operators in any given sector in developing countries; finding proper comparable data can be very difficult;
2. The comparable information in developing countries may be incomplete and in a form which is difficult to analyse, 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 usually very costly to access; and
3. Transition countries whose economies have just opened up or are in the process of opening up may have “first mover” companies who have come into existence in many of the

sectors and areas hitherto unexploited or unexplored; in such cases there would be an inevitable lack of comparables.

1.10.7. Given these issues, critics of the current transfer pricing methods equate finding a satisfactory comparable to finding a needle in a haystack. Overall, it is quite clear that finding appropriate comparables in developing countries for analysis is quite possibly the biggest practical problem currently faced by enterprises and tax authorities alike, but the aim of this Manual is to assist that process in a practical way. Chapter 5 of this Manual provides analysis and practical examples on Comparability Analysis.

Lack of knowledge and requisite skill-sets

1.10.8. 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 regulations have, however, helped some developing countries in creating requisite skill sets and building capacity, while also protecting their tax base.

Complexity

1.10.9. Rules based on the arm's length principle are becoming increasingly difficult and complex to administer. Transfer pricing compliance may involve expensive databases and the associated expertise to handle the data. Transfer pricing audits need to be performed on a case by case basis and are often complex and costly tasks for all parties concerned.

1.10.10. In developing countries resources, monetary and otherwise, may be limited for the taxpayer (especially small and medium sized enterprises (SMEs)) which have to prepare detailed and complex transfer pricing reports and comply with the transfer pricing

regulations, and these resources may have to be “bought-in”. Similarly the tax authorities of many developing countries do not have sufficient resources to examine the facts and circumstances of each and every case so as to determine the acceptable transfer price, especially in cases where there is a lack of comparables. Transfer pricing audits also tend to be a long, time consuming process which may be contentious and may ultimately result in “estimates” fraught with conflicting interpretations.

1.10.11. 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 “e-commerce economy”

1.10.12. 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.

1.10.13. The different kind of challenges thrown up by fast-changing web-based business models cause special difficulties. From the viewpoint of many countries, it is essential for them to be able to appropriately exercise taxing rights on certain intangible-related transactions, such as e-commerce and web-based business models

Location savings

1.10.14. 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.

1.10.15. 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 pricing

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 regulations provide some sort of limited guidance in the form of recognizing that adjustments for significant differences in cost attributable to a geographic location must be based on the impact such differences would have on the controlled transaction price given the relative competitive positions of buyers and sellers in each market. The OECD Guidelines also consider the issue of location savings, emphasizing 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 5 and some specific country practices on the use of location savings are provided at Chapter 10.

1.11. Summary and Conclusions

1.11.1. Transfer pricing is generally considered to be the major international taxation issue faced by MNEs today. 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.

1.11.2. Transfer pricing is a difficult challenge for both governments 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 pricing methods.

1.11.3. 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 development, and with increasing globalization the potential loss of revenue may run into billions of dollars.

1.11.4. 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 internationally coherent, seeking to reduce compliance costs and reduce unrelieved double taxation.

1.11.5. This chapter aimed to introduce the fundamentals of the concepts involved in transfer pricing such as the arm's length principle and issues related to it. Subsequent chapters will deal with specific transfer pricing concepts in greater detail.

Chapter 2

BUSINESS FRAMEWORK

2.1. Introduction

2.1.1. This chapter provides background material on Multinational Enterprises (MNEs); MNEs are a key aspect of globalization as they have integrated cross-border business operations. This chapter 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).

2.1.2. MNEs are groups of companies and generally operate worldwide through locally incorporated subsidiaries or permanent establishments; they may also use other structures such as joint ventures and partnerships. At the operational level, an MNE's business 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.

2.1.3. This chapter then uses a "value chain analysis" (see Paragraphs 2.2.5 and 2.3.5 below) as a measure for testing the performance of an MNE. It considers the management of the transfer pricing function in an MNE to minimize the risk of transfer pricing 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 documentation requirements; reporting for transfer pricing purposes; dealing with audits; and appropriate measures for dispute resolution with a tax authority.

2.2. Theory of the Firm and Development of Multinational Enterprises

2.2.1. 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.²¹ These transactions would require contracts between the independent producers but a significant part of these resources would be used in the process of making contracts.

2.2.2. The expenses of making contracts are called “transaction 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.

2.2.3. Within a firm, contracts between the various factors of production are eliminated and replaced with administrative arrangements. Usually, the administrative costs of organizing production within a firm are less than the cost of the alternative, which is outsourcing 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.

2.2.4. A firm will internalize the costs of production to the extent that it can achieve economies of scale in production and distribution and establish coordination economies. The United Nations Conference on Trade and Development (UNCTAD) in its *1993 World Investment*

²¹UNCTAD, “World Investment Report 1993: Transnational Corporations and Integrated Production”, (New York, 1993). Available from <http://unctad.org/en/pages/PublicationArchive.aspx?publicationid=640> at page 115; Ronald Coase, “The Firm, the Market and the Law”, (Chicago: University of Chicago Press, 1988) at page 7.

*Report: Transnational Corporations and Integrated Production*²² noted that in many industries the expansion of internalized activities within multinational enterprises indicates that there are significant efficiency gains that may be achieved.

2.2.5. 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 sequence of processes involved in the production and distribution of a commodity."²³ 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."²⁴

2.2.6. MNEs create organizational structures and develop strategies to arrange the cross-border production of goods and services in locations around the world and to determine the level of intra-entity or 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.²⁵

2.2.7. Successful MNEs use their location and internalization advantages to maximize their share of global markets and growth

²²UNCTAD, "World Investment Report 1993: Transnational Corporations and Integrated Production", (New York, 1993). Available from <http://unctad.org/en/pages/PublicationArchive.aspx?publicationid=640> at pages 7 and 153-154 especially.

²³Oxford English Online Dictionary.

²⁴Oxford English Online Dictionary.

²⁵UNCTAD, "World Investment Report 1993: Transnational Corporations and Integrated Production", (New York, 1993). Available from <http://unctad.org/en/pages/PublicationArchive.aspx?publicationid=640> at page 158 and following.

opportunities. Thus, multinational enterprises are able to minimize their costs through their integration economies, which are not available to domestic firms.

2.2.8. 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 providing services such as advisory, research and development (R&D), legal, accounting, financial management, and data processing from one or several regional centres to group companies. Also, management teams of an MNE can be based in different locations, leading the MNE from several locations.

2.2.9. 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 establishing infrastructure and improving the education of individuals and accordingly providing economic benefits to the country.

2.2.10. MNEs have common control, common goals and common resources, in which the units of the enterprise — parent company, subsidiaries 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 methods for allocating the income and costs of MNEs between jurisdictions for tax purposes.

2.2.11. In *Multinational Enterprises and the Global Economy* (2008)²⁶ 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 operations until

²⁶John Dunning and Sarianna Lundan, “Multinational Enterprises and the Global Economy”, 2nd edition, (Cheltenham, Edward Elgar, 2008) at page 197.

the late 1980s and then more recently chose to outsource some activities in which they do not have competitive advantages.

2.2.12. 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 functions. Up to the 1960s and 1970s, MNEs had engaged in limited or no outsourcing of operations and they became large integrated conglomerates. But the authors argue that from the late 1980s MNEs began outsourcing many activities that were previously performed by the firms themselves.²⁷ 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.

2.2.13. MNEs examined their value chains to identify the functions in which they had no advantage over other firms.²⁸ 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 operations through a network of contractual arrangements with independent enterprises and cooperative in-house relationships.

2.2.14. 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

²⁷Refer to footnote 26, especially at page 196.

²⁸Refer to footnote 26, especially at page 196.

usually incur the additional requirement of complying with transfer pricing rules. Some SMEs may face challenges in complying with transfer pricing rules because of their lack of expertise with international tax issues in general and limited compliance resources that may hinder them from 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 simplified documentation requirements, and may use flexible approaches in handling transfer pricing issues involving SMEs. This creates the need to define an SME. Although there is no universal definition, an SME may be defined on the basis of criteria including: turnover; balance sheet value; number of employees; and transaction values.

2.3. Legal Structure

2.3.1. General Principles of Company Law

2.3.1.1. The legal systems used by countries include the common law and civil law systems. The common law system originates in the UK and is used in 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 perpetual life and limited liability. The domestic law treatment of a partnership varies in common law and civil law countries.

2.3.1.2. 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 respective shares of partnership income. Other countries treat partnerships as taxable units subject to taxation as entities, including company treatment. Some countries such as the USA have limited liability companies 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 concurrent 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 beneficiaries. 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.

2.3.1.3. One of the key decisions facing any MNE when expanding 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 companies (associated enterprises) or operate abroad using permanent establishments (branches). Foreign subsidiaries may be either fully-owned by the parent company or partly-owned.

2.3.1.4. An MNE is a group of companies or other entities and under the company law of the country in which each company is incorporated 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.

2.3.1.5. 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.

2.3.1.6. MNEs may also carry on business abroad through a partnership 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 independent entities or subsidiaries. Joint ventures involve independent companies 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 example, commencing operations in a jurisdiction using a joint venture structure and then buying out the joint venture partner and operating in that jurisdiction through an associated enterprise. An MNE may also operate abroad using an agent, which may be an independent agent, a dependent agent or a commissionaire.

2.3.2. Companies and Permanent Establishments

2.3.2.1. 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 legislation and its tax treaties.

2.3.2.2. 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 operational 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 divisional structure or a matrix structure as outlined below.

2.3.3. Types of Organizational Structures

2.3.3.1. 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 producing a limited amount of products or services efficient and predictable.

2.3.3.2. Under a **divisional structure**, each organizational function is grouped into a division with each division containing all the necessary resources and functions within it, such as human resources and accounts. Divisions can be categorized from different points of view. The distinction could for example be made on a geographical basis (e.g. a China division or a West Africa division) or on a product/service basis (e.g. different products for different customers: households or companies). For example, an automobile company may have a divisional structure with a division for hybrid cars and another division for other cars with each of these divisions having its own sales, engineering and marketing departments.

2.3.3.3. The **matrix structure** groups employees by multiple criteria with the most common criteria being function and product. 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.

2.3.4. Financial Reporting

2.3.4.1. 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 challenging for an MNE to attempt to segregate the corporate and statutory financial statements to reflect the organization's operational structure.

2.3.5. Value Chain Analysis

2.3.5.1. The aim of MNEs is to maximize profits from producing goods and services. The key feature of an optimal MNE business is to produce a profit from exploiting resources which produce property 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 analysing 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.

2.3.5.2. 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 manufacturing 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.

2.3.5.3. 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 analysing the transfer pricing implications of the value chain.

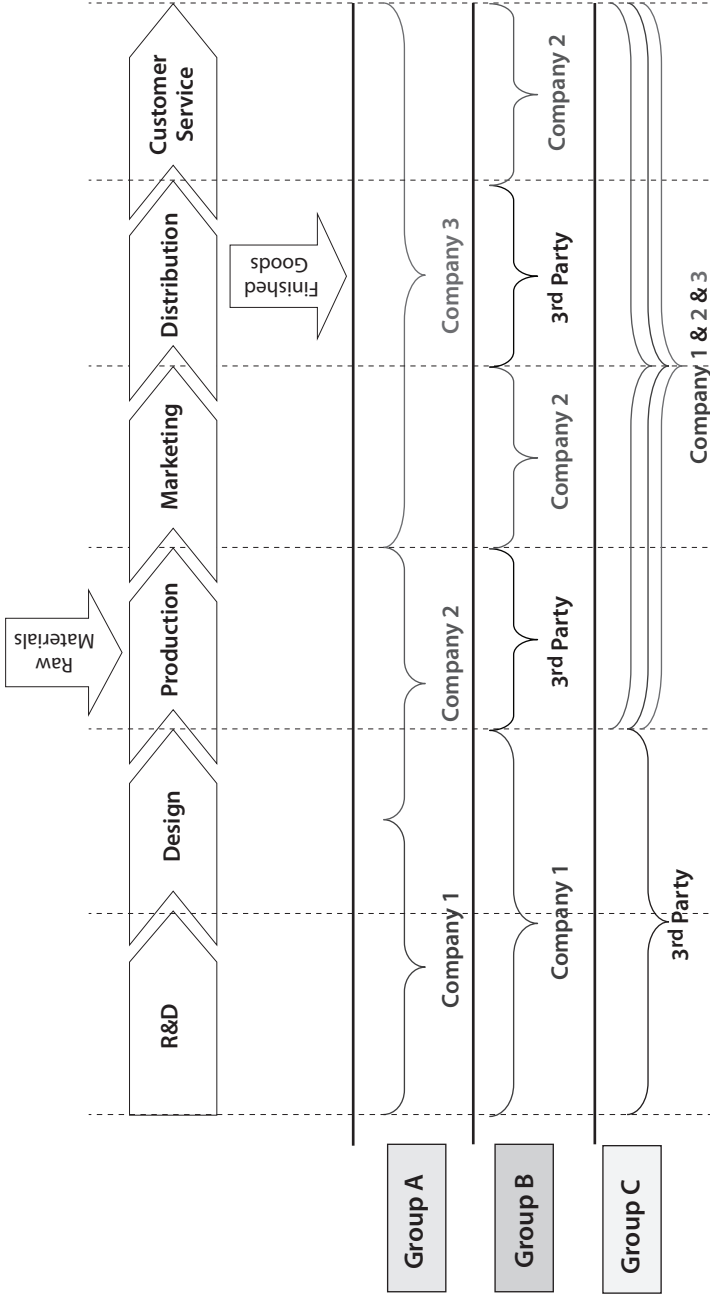
2.3.5.4. For example, in MNE group A (see Figure 2.1 below) the value chain is defined as Company 1 performing R&D, Company 2 manufacturing, and Company 3 distributing the MNE's products. The value chain, however, may be different depending on the legal and contractual arrangements between the companies.

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

2.3.5.6. 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 developed through that R&D, and Company 3 acts as a limited risk distributor through a contractual arrangement with Company 2. In this case, Company 2 is the legal owner of the intangible property of the MNE, and bears substantial risk associated with the manufacturing and sales of the MNE's products.

2.3.5.7. 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 developed through that R&D, and Company 2 acts as a limited risk contract manufacturer

Figure 2.1: Value Chain Analysis*



*Examples of how different groups could "customize" the above generic value chain:

through a contractual arrangement with Company 3. In this case, Company 3 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.

2.3.5.8. As will be discussed in subsequent chapters, each of these different contexts would very likely result in different transfer pricing outcomes.²⁹

2.4. Managing the Transfer Pricing Function in a Multinational Enterprise

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

2.4.2. Entities in an MNE group conduct global business that gives rise to opportunities to optimise 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 acceptable to the tax authorities in the countries in which the MNE operates. The transfer pricing challenge becomes even greater when the MNE has multiple global businesses with different business models and multiple cost centres. The size of the MNE adds to the complexity.

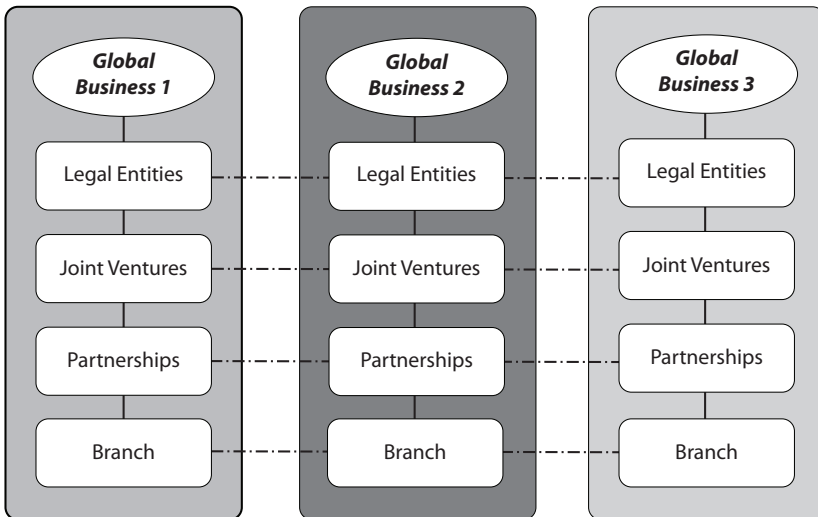
2.4.3. Financial reporting for MNEs are informed by two decision trees. On the one hand, corporate and tax law require an associated enterprise to determine its taxable income derived from a specific jurisdiction. On the other hand, an MNE will usually need to determine for management purposes the income and costs of its businesses lines, which, as the previous discussion shows, can operate across

²⁹Contractual 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 economic substance of the arrangements is consistent with the legal form of the arrangements, and 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.

2.4.4. The following is an illustrative example of the two different decision trees within an MNE:

Figure 2.2: Multinational Enterprise Decision Trees



2.4.5. 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 enterprises it is very difficult to allocate the profits and costs to all the separate 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.

2.4.6. The arm's length principle allows national tax authorities 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 similar circumstances. A tax authority should only disregard a controlled transaction in exceptional circumstances. If the terms of a transaction between associated enterprises differ from those between unrelated parties and comparisons are difficult to make, an MNE bears the risk of transfer pricing adjustments. If the income of an associated 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 proportionate reduction in the income of the other associated enterprise in Country B, provided a consistent transfer pricing method is used by both countries.

2.4.7. But Country B may use different transfer pricing methods. 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 transfer pricing function within an MNE to limit the risk of transfer pricing adjustments and the risk of double taxation. Illustration of double taxation below in Figure 2.3.

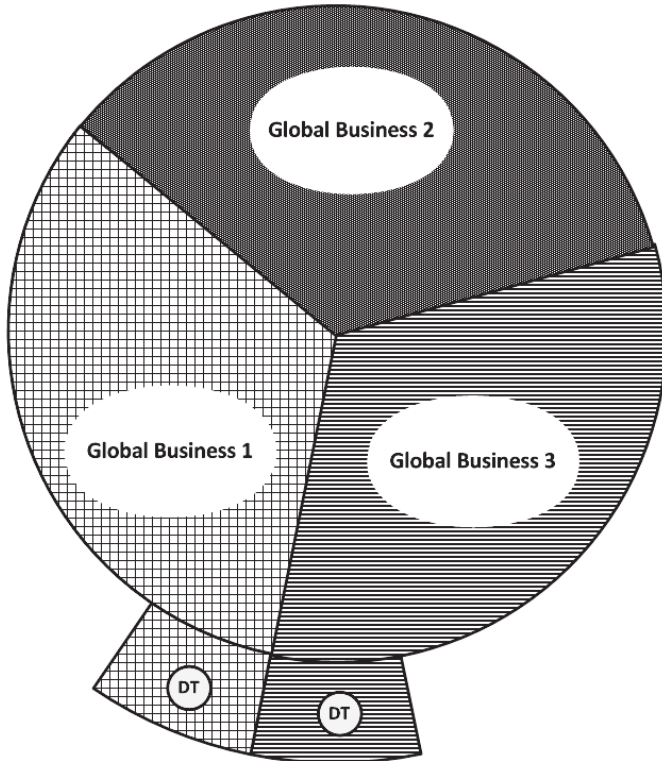
2.4.8. In principle, designing, implementing and documenting an appropriate transfer pricing policy should not be viewed solely as a compliance issue for MNEs. The main goal should be to develop a consistent global policy which cannot be altered to exploit tax laws. A well-developed and consistently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

2.4.9. An MNE's transfer pricing policy should ideally reduce the risk of transfer pricing adjustments and the risks of double taxation of cross-border transactions. A comprehensive transfer pricing policy should cover four key areas as shown in Figure 2.4.

- Advisory;
- Reporting;

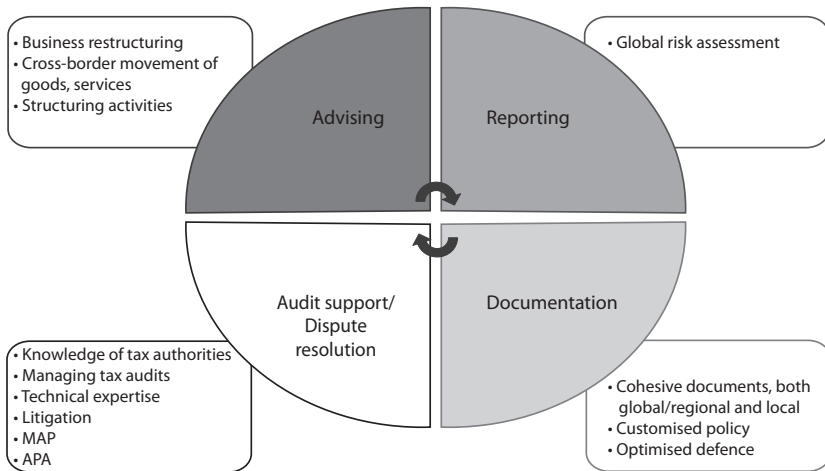
- Documentation; and
- Audit support/Dispute resolution.

Figure 2.3: Global Effects Transfer Pricing Adjustments
(before adjustment)



- Country challenges amount of profit reported by legal entity
- Consequence: total global profit increases
- End result: Some profit is taxed twice (double taxation – (DT))

Figure 2.4: Aspects of Transfer Pricing Policy



2.4.10. Advising requires a thorough knowledge of an MNE’s business 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 pricing adjustments and therefore optimize the business opportunity if the tax department is involved in an MNE’s decision-making.

2.4.11. 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 documentation (masterfiles) 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.

2.4.12. Tax authorities around the world are increasingly focused on transfer pricing and on expanding their transfer pricing capabilities. 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.

2.4.13. Tax authorities should not start from the assumption that MNEs are manipulating their results in order to obtain tax benefits. 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.

2.4.14. 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 price rules. Despite the efforts MNEs invest in setting the appropriate transfer prices and preparing comprehensive documentation, there is always the risk that tax authorities disagree with the approach taken and there is thus the risk of a transfer 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 profits from one jurisdiction to another to gain tax benefits including low-taxation or no-taxation.

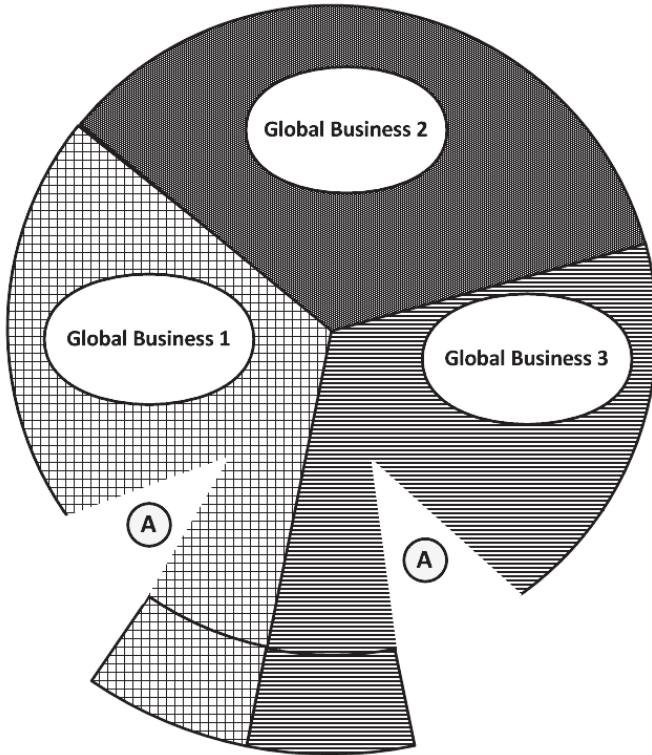
2.4.15. Transfer pricing rules are considered very useful by MNEs if they are able to achieve a globally consistent approach and eliminate the risk of transfer pricing disputes. If in one country an MNE’s transfer prices are adjusted, resulting in a higher taxable income, the associated enterprise in the other country should in principle³⁰ 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.

2.4.16. 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 procedure mechanism in a tax treaty.

³⁰UN and OECD Model Tax Conventions, Article 9 (Associated Enterprises).

2.4.17. The following diagram illustrates a transfer pricing adjustment to relieve double taxation:

Figure 2.5: Global Effects Transfer Pricing Adjustments
(after adjustment)



- Adjustment (A) is basically a profit allocation issue between countries
- Increase of profit in Country A must result in corresponding adjustment in Country B

Chapter 3

GENERAL LEGAL ENVIRONMENT

3.1. Introduction

3.1.1. Transfer pricing rules were introduced in domestic legislation 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 1, Paragraph 1.3 for more on the evolution of transfer pricing rules.

3.1.2. Domestic transfer pricing regulations worldwide show some harmonization in basic principles, in accordance with the arm’s length standard, even if the application is not identical across jurisdictions. The introduction of transfer pricing rules has taken place within different legislative traditions, and in the context of the sovereign right for 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 action treaties, and have therefore already committed to it; and
- The benefits of similar approaches between countries in terms of avoiding double taxation.

3.1.3. With the increase of cases where tax authorities have made adjustments to transfer prices set by the related entities, taxpayers increasingly seek practical dispute resolution mechanisms to avoid double taxation. As a result, Competent Authority (CA) discussions

as set out in the MAP under bilateral treaties³¹ have been made more effective through supplementary domestic regulations and international agreements, as well as practice regarding the conduct of those procedures.

3.1.4. Many countries have implemented 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.³² The advantages and disadvantages of these solutions are dealt with in Chapter 9 of this Manual; however, the application of these solutions will be influenced by the legal environment of each country, and thus will take place in a variety of styles.

3.1.5. 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 legislation of another country which is examined as a source of ideas should be considered closely as to why it has worked or has not worked in its original context, including ease of practical administration of the rules it contains. Those reasons and the “environment” of the legislation should be compared with those in the user’s country. 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.

3.2. Domestic Transfer Pricing Legislation: Structural Overview

3.2.1. As already noted in Chapter 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 taxable income from one company within an MNE, located in a high-taxing jurisdiction, to another company of the same group, in a low-taxing

³¹Based upon Article 25 of both the UN and OECD Model Conventions.

³²A MAP as such cannot guarantee a resolution since it doesn’t force the competent authorities of the country to agree.

jurisdiction, through incorrect transfer prices. The aim of such practices is to reduce the overall tax burden of the group. This involves a transfer price of course, but is more accurately referred to in this Manual as one type of transfer mis-pricing since 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 1, Paragraph 1.1.7. for examples.

3.2.2. Many countries have introduced specific domestic tax rules to prevent possible tax base erosion through incorrect 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 Paragraph 3.7 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.

3.2.3. Another principle for transfer pricing income allocation is global formulary apportionment (GFA), see Chapter 1, Paragraph 1.4.13. 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 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 the GFA acknowledging that the 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 principle 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 longer term advantages and disadvantages of any possible alternative ways of dealing with transfer pricing, including GFA.

3.2.4. 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:

3.2.4.1. The first possible legislative approach simply authorizes the tax administration to distribute, apportion or allocate gross income, deductions, credits etc when they determine that such distribution, apportionment, or allocation is necessary in order to prevent tax evasion or clearly reflect the income of any of such organizations, trades, or businesses.³³ Under this system there is no reference to the taxpayer's compliance obligation in determining the arm's length principle, while the arm's length principle is stipulated not in the general legislative principle but rather, if at all, within regulations supporting the legislation.

3.2.4.2. 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.³⁴ 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 type of statute effectively requires taxpayers to conduct their initial tax accounting based on the arm's length principle.

3.2.5. A country's choice between the two above alternatives will depend on the basic principles of domestic tax law in that country. This will include issues such as the form of anti-avoidance legislation, where to place the burden of proof, etc. However, the choice of styles of domestic legislation has made no substantial difference in the legal procedure of structuring the arm's length principle. Arm's length methodologies stipulated in each country's legislation will, however, differ to some extent, as described below.

³³E.g., US Internal Revenue Code §482.

³⁴E.g., Japan Special Taxation Measure Act §66-4(1).

3.2.6. 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. Other countries might opt only to identify the basic structure of tax base allocation among the related parties under the arm's length principle. In the latter case, detailed practical guidance should normally be available in subordinate legal materials, such as regulations, administrative rules and public notices, etc. While depending upon the legal system of the state concerned, the tax law of certain states may define in great detail issues such as what constitutes a "related party", transfer pricing methodologies, documentation, penalties and APAs. Other states might opt to only identify the basic structure of tax base allocation among the related parties under the arm's length principle. 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 therefore consider the level of guidance available in their countries, and determine if further detail is needed.

3.2.7. There remains substantial risk of double taxation even when two countries are following 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 different from one country to another or in relevant tax treaties, 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.

3.3. Associated Enterprises

3.3.1. The definition of which companies, and therefore transactions, are covered by transfer pricing legislation is a key issue since the arm's length principle applies to transactions between related companies. 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, Sub-Paragraph 1a) or 1b) with respect to the other enterprise. These sub-paragraphs cover so-called parent-subsidiary relationships and brother-sister relationships as relevant situations.

The requirement of control in each sub-paragraph is defined as being to “participate directly or indirectly in the management, control or capital of an enterprise”. There is no specific common guidance on this matter either in the Commentaries on Article 9 in the UN and OECD Models, or in the OECD Transfer Pricing Guidelines. This is mainly because transfer pricing issues are relevant only if special conditions have been made or imposed between two parties. Thus, the degree of control as a threshold for triggering transfer pricing legislation has in effect been left to domestic legislation.

3.3.2. Many countries apply a 50 per cent shareholding threshold as the degree of participation required for “associated” status; some countries employ a lower threshold. However, countries with higher thresholds usually employ substantive rules on control as a fall-back, or subsidiary, test. These may focus on other elements than shareholding, such as dependency of input materials, distribution networks, financial resources and human resources, etc on other group members. There is thus no significant difference among countries on this matter.

3.3.3. Differing threshold criteria can result in disputes in certain circumstances. For example, in Japan domestic law stipulates that a shareholding of 50 per cent or more is the threshold for an “associated enterprise”, which is generally a possible target of transfer pricing examination by tax authorities. This may bring into the examination “net” a 50/50 joint venture project organized by two independent parties.³⁵ The National Tax Agency of Japan has therefore issued an additional public notice that requires examiners to conduct an in-depth analysis of control in such joint venture type operations.

3.3.4. For developing countries, analysis of control might be an important challenge in ensuring that their transfer pricing legislation can be administered effectively. In addition, factors for identifying control should be carefully examined because evaluation of those factors requires complicated fact-finding procedures which might differ depending on industry sector, geographic characteristics, product cycle, etc.

³⁵An 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.

3.4. Coverage of Transactions and Availability/Priority of Transfer Pricing Methods

3.4.1. Transfer pricing generally covers all cross-border transactions involving a country, regardless of whether participants are residents or non-residents. Thus, transactions conducted between a foreign company that has a permanent establishment (PE) in another jurisdiction and its affiliate company located abroad are also taxable events under domestic law. 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.

3.4.2. 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 generally prevails in an equivalent manner, the legal framework of taxation should be differentiated. For example, the dispute resolution mechanism might be different depending on each country's domestic law and the relevant treaty.

3.4.3. The choice of method, availability of different types of methods and the priority to be given to various different transfer pricing methods are matters often covered by domestic legislative frameworks. Priority and comparability 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 6, including that there is no longer considered to be a "hierarchy" of methods.

3.5. Practical Guidance for Cases Without Sufficient Comparables

3.5.1. The most critical issue for developing 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 independent comparables should be a key focus in domestic legislative frameworks. 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 5 on Comparability Analysis in particular. Domestic legislative frameworks and administrative guidelines should generally address 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.

3.5.2. In clarifying the procedures, it is useful to consider some real-world examples of transfer pricing adjustments conducted by developing countries which have used different country or different industry sector databases. Such examples may be drawn from actual cases in other countries; examples for specific areas are provided elsewhere in this Manual.

3.5.3. 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 documentation 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.

3.5.4. Some differences in the coverage of transactions or in the legal form (statutes with penalty provisions or administrative guidance on self-assessment) will remain. It is therefore appropriate to continuously evaluate documentation and penalty legislation for efficiency and proportionality. The experience of some developed countries may be relevant to developing countries just starting to develop capability in transfer pricing. For example, 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 taxpayers 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.

3.6. Burden of Proof

3.6.1. The burden of proof in tax litigation refers to the necessity 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 at trial. A concept which 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.

3.6.2. 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; when a transfer pricing assessment is disputed it may ultimately end up in court.

3.6.3. The burden of proof for transfer pricing litigation may be determined in accordance with the burden of proof rules of civil procedure or tax litigation in general. 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 United States, Canada, Australia, India and South Africa.

3.6.4. 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) 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 deficiency or has attempted to increase the deficiency amount relating to transfer pricing after the issuance of the notice of deficiency.

3.6.5. In Canada the burden of proof rests on the taxpayer because it is the rule in any litigation.

3.6.6. In Australia the burden of proof is on the taxpayer, as documentation demonstrating that the terms and conditions of its transactions 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 otherwise be determined.

3.6.7. 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 determined in accordance with the provisions of the law or that the information or data used in the computation is not reliable or correct.

3.6.8. In South Africa Section 82 of the Income Tax Act (ITA) provides that the burden of proof that any amount is: (1) exempt from

tax chargeable under the ITA, (2) subject to any deduction, abatement or set-off under ITA or (3) to be disregarded or excluded from capital gains tax, rests with the taxpayer. Upon the hearing of any appeal from any decision of the South African Revenue Service (SARS) to disallow an objection the decision may not be reversed or altered unless it is shown by the taxpayer that the SARS decision is wrong.

3.6.9. The position that the tax authorities bear the burden of proof is taken, e.g., by France, Germany, the Netherlands and Japan.

3.6.10. 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.

3.6.11. 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 taxpayer'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.

3.6.12. 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 documentation 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.

3.6.13. In Japan the government has the burden of proof when a taxpayer seeks to overturn a disposition 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 administration to undertake its examination of whether the arm's length requirements 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.³⁶

3.6.14. Tax administrations and taxpayers may encounter several challenges in meeting their respective burdens of proof. As a practical matter, associated enterprises normally establish the conditions for a transaction at the time the transaction is undertaken. In auditing

³⁶In this case the tax authorities compared the personal services function of the tested party (the Japanese subsidiary that was paid by its foreign parent company for performing personal services to assist the parent company'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.

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 an administrative burden for both the taxpayer and the tax administration in evaluating significant numbers and types of cross-border transactions. The tax administration would review any supporting documentation prepared by the taxpayer to show that its transactions are consistent with the arm's length principle. The tax administration may also need to gather information on the comparable uncontrolled transactions and the market conditions at the time the transactions took place, for numerous and varied transactions. Such an undertaking usually becomes more difficult 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.

3.6.15. The divergent rules on the burden of proof between two countries engaged in the Mutual Agreement Procedure (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 administrations 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.

3.6.16. It should be noted that in practice the burden of proof is not always a deciding factor. The burden of proof requirement nevertheless plays an important role in deciding who should disclose what. Since burden of proof is a general issue 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.

3.7. Presumptive Taxation Approaches and the Arm's Length Principle

3.7.1. 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 reassess the taxpayer’s taxable income on that basis. Such provisions are generally only regarded as applicable in case of the taxpayer’s failure to provide documentation on the arm’s length price within a reasonable time (such as when information is requested of a taxpayer during an audit). Presumptive taxation is usually provided for as a last resort to fight against the manipulation of transfer pricing.

3.7.2. This methodology may be common in statutes operating in relation to domestic taxation and transfer pricing adjustments. However, transfer pricing adjustments in relation to foreign transactions generally create a risk of international double taxation. Most countries therefore structure such statutes 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.

3.7.3. To invoke presumptive taxation in Japan, the statute allows the tax authority to use the “gross profit rate” methods which are very similar to the Resale Price Method and the Cost Plus Method, and, if such methods are not available, the profit methods. 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.

3.7.4. As stated earlier, Japan introduced the examiners’ authority to inquire into third party transactions at an early stage of its transfer pricing journey. The condition to make use of this authority is that when examiners request the 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” caused some disputes, when taxpayers insisted that they had 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 administration 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. In Japan, in conjunction with the long-standing “hierarchy” in transfer pricing methods, this issue has remained decisive for the outcome of lawsuits.

3.7.5. 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 focussed system where taxpayers have an initial burden of proof on the authorities’ adjustment, a penalty system may play a more effective role than presumptive taxation.

3.7.6. 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 are 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.³⁷

3.7.7. A specific example may be considered to contrast the position in a non-OECD country. In India, at times, information is called for from comparable companies to ascertain the correct factual

³⁷OECD, “Transfer Pricing Guidelines for Multinational Enterprises” at Paragraph 3.36. The 2011 Japanese tax law reform followed this disclosure policy.

position regarding their 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.

3.8. Safe Harbour Rules

3.8.1. Safe harbour rules are rules whereby if a taxpayer's reported profits are below a threshold amount, be it as a percentage or in absolute terms, a simpler mechanism 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 categorize as safe harbours. For example, another simplified mechanism sometimes used enables a company to avoid making a transfer pricing adjustment where the ratio between international transactions and the overall transactions of a given company is smaller than a percentage stipulated in the law or regulation. A further example relates to the interest rate for an inter-company loan, which may be accepted if it is within a range determined by tax law based on the capital market rates.³⁸ 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.

3.8.2. Safe harbour rules can be an attractive option for developing 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 advantage of low compliance costs and certainty for taxpayers, as well as administrative simplicity for tax authorities.

3.8.3. It is often stated that safe harbours allow tax administrations (especially when they are just beginning to administer transfer pricing laws) to focus their limited resources, including audit resources,

³⁸Such a mechanism has, for example, been adopted in Brazil.

on the worst cases of non-arm's length transfer pricing, especially high-margin transactions. Given the difficulties of information collection and analysis of data, many developing countries might consider that at least in small-scale cases, safe harbour rules contribute to minimizing the complexity of establishing an arm's length price, which requires collection and analysis of data. The complexity might be disproportionate to the size of the taxpayer or its level of controlled transactions.³⁹

3.8.4. 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,⁴⁰ interest rates in respect of short-term inter-company "plain vanilla" (i.e. on standard terms) loans of moderate value, etc.

3.8.5. There are possible down-sides 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 hard 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 unnecessarily foregone. 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

³⁹OECD, "Transfer Pricing Guidelines" at Paragraph 4.94–4.101.

⁴⁰See the Communication from the Commission to the European Parliament, 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://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/transfer_pricing/forum/c_2011_16_en.pdf

to which the safe harbours will not apply. Safe harbours may thus even be a discouragement of investment in high-margin activity as compared to low-margin activities.

3.8.6. The OECD Transfer Pricing Guidelines discuss some potential disadvantages of a safe harbour rule, such as the high risk of double taxation, tax planning, difficulties with the Mutual Agreement Procedure and equity and uniformity issues. Following this analysis, the OECD Guidelines recommend administrative flexibility in dealing with small-size cases instead of safe harbour rules. However, it should be noted that an update of the language of Chapter IV of the OECD Transfer Pricing Guidelines relating to safe harbours is being prepared.⁴¹

3.8.7. 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 taxation. Under this scheme, the NTS used a standard offer commission rate based on a survey on actual commission rates. This was available as a last resort under its ruling only in cases where other methods for identifying the arm's length rate were inapplicable in determining commission rates received from a foreign party. The NTS finally repealed this ruling as it considered the ruling to be contrary to the arm's length principle. These developments were accompanied by targeted training projects for international examiners within the NTS, to make the necessary adjustments to practice.

3.8.8. In India, the safe harbour rules were yet to be formalized at the time of drafting of this Manual. However the committee formed for recommending safe harbour rules examined the implementation of these rules in the light of the above mentioned constraints and has submitted its report to the government.

⁴¹Work commenced in 2012. Final guidance on safe harbour provisions, giving a more balanced assessment of safe harbour measures that reflects actual country practice, will be published in 2013.

3.9. Adjustments

3.9.1. 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 guidance available only indicates that tax administrations may or may not grant the request for downward adjustment at their own discretion.⁴² It adds that tax administrations may also consider such requests in the context of MAPs and corresponding adjustments. This is an issue which developing countries should also consider when designing their domestic legal environment for transfer pricing.

3.9.2. The Republic of Korea's experience may be considered as an example in this regard. In 2010, the Republic of Korea clarified in its tax law that a downward adjustment should be applied in cases where a tax adjustment is made under a transfer pricing method using multiple year data. Therefore, tax officials are no longer given any discretion to make the adjustment only for years with a deficient profit, and disregard years with excess profits, when they adjust the taxpayer's profit level under a transfer pricing method using multiple year data.

3.10. Advance Pricing Agreements/Arrangements

3.10.1. Advance Pricing Agreements/Arrangements (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 applications for APAs has reached almost the number of adjustment cases in some developed countries.⁴³ On the other hand, although unilateral APAs are categorized as partial solutions for double taxation, they are also considered useful in specific cases depending on all the facts and circumstances.

⁴²OECD, "Transfer Pricing Guidelines" at Paragraph 3.17.

⁴³In 2010, Japan received 127 applications for APAs, whereas it adjusted 100 cases after examination.

The OECD Transfer Pricing Guidelines strongly endorse the APAs as a supplement to the traditional administrative, judicial and treaty mechanisms for resolving transfer pricing issues.⁴⁴

3.10.2. One of the key advantages of adopting an APA system is that MNEs tend to establish a consistent global pricing policy for their inter-company transactions. Developing countries thus have a good opportunity to obtain access to the existing documentation which is relevant to their local operations. A second advantage is that if an APA has been agreed between other countries regarding similar transactions they have a good chance to refer to that existing APA as relating to a comparable transaction. As a third advantage, if the MNE concerned applies for an APA in its own residence jurisdiction on the transaction with a local subsidiary, any existing APA can be a good reference. In any case using APAs should, after the initial efforts, reduce administrative and compliance burdens later and allow those resources to be focussed more productively elsewhere.

3.10.3. Other 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 capabilities before they can properly evaluate what is an appropriate APA for them.⁴⁵ Other countries are concerned that APAs are not useful in the early years of a transfer pricing regime because they tend to be sought by companies that are in broad conformity with the arm's length principle and may divert scarce resources from achieving compliance in the worst cases of avoidance. As with any such mechanism, checks and balances must be provided to ensure that the APA process is applied consistently between taxpayers and is not subject to abuse or integrity issues. The advantages and disadvantages of APAs are discussed in more detail in Chapter 9 on Dispute Avoidance Resolution; 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.

⁴⁴At Paragraph 4.123-4-165. In addition, see the Annex to Chapter 6 on "Guidelines for conducting APA under the MAP".

⁴⁵For example, under existing legislation at the time of writing this chapter, India did not have any regulation dealing with APAs. However, India has introduced APAs from 1 July 2012.

3.11. Dispute Resolution

3.11.1. As stated earlier, an upward transfer pricing adjustment generally causes substantial double taxation for the cross-border business, unless there is a “corresponding adjustment” downward on the other side of the transaction — i.e. by the other country’s tax authority. For this purpose, countries should take into consideration domestic dispute resolution procedures as well as treaty-based dispute resolution mechanisms when designing a transfer pricing regime. Domestic remedies are expected to work effectively for transfer pricing cases, unless a transfer pricing adjustment lacks a domestic legal basis or neglects procedural requirements. However, even when a taxpayer partially wins the case, the double taxation arising from an adjustment is still not recovered unless the MAP works successfully to reach agreement on the arm’s length result between the concerned treaty partners, with one treaty partner making a corresponding adjustment in its jurisdiction. In addition, the 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 transfer 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.

3.11.2. 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 9; however, for the purposes of the present chapter, the need to accommodate treaty obligations and processes should be taken into account in the design of the legal environment.

3.11.3. 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 arbitration 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.

3.11.4. 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 conditions at the initial stage of the design and implementation of the transfer pricing regime. There may be differences as between the two Competent Authorities' abilities to access information on transfer pricing methods; 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 information. A further problem is the lack of experience in conducting a MAP on transfer pricing cases. Some consider adequate levels of experience to be necessary before the appropriate type of APA can be achieved, while others see the experience gained in APAs as an important part of capacity building on transfer pricing issues. Matching capability with the transfer pricing regime is thus an important factor in the design of the domestic legal environment.

3.11.5. The Japanese experience can be considered as one reference 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 information 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 within a two year period such as now contained in a target at Article 25(5) of the OECD Model Convention. After stabilizing its own capacity building for MAP, Japan has made some contributions in this area, bilaterally or multilaterally, for the benefit of new negotiating partners.

3.11.6. The Indian experience in this regard has been somewhat similar. The Indian Competent Authority has been successfully negotiating with treaty partners for the settlement of cases under MAP. After years of experience gained from negotiations with treaty partners and improvements with regard to the exchange of information, the Indian Competent Authority has been successful in concluding settlements of large cases.

Chapter 4

ESTABLISHING TRANSFER PRICING CAPABILITY IN DEVELOPING COUNTRIES

4.1. Introduction

4.1.1. 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:

1. The relationship between tax policy and tax administration;
2. The need to evaluate current capabilities and gaps to be filled;
3. The need for a clear vision, a mission and a culture that reflects them;
4. Organizational structure;
5. Approaches taken to building team capability;
6. The need for effective and efficient business processes;
7. The advantages of staged approaches to reaching long-term goals; and
8. The need for monitoring to assess effectiveness and for fine tuning.

4.1.2. 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.

4.2. Relationship between Tax Policy/Tax Administration

4.2.1. 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)⁴⁶ 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;
- The international dimension given the link to binding tax treaties through provisions based upon Article 9 of the UN and OECD Model Conventions, issues of potential double taxation and the interest of other countries; and the large amounts of money that may be at stake.

4.2.2. 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.

4.2.3. 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:
 - Where aspects of the policy are expensive or otherwise very resource intensive to administer, and the likely revenue return is not commensurate with these costs;
 - Where a wider treaty framework and strong exchange of information provisions would be beneficial; or where

⁴⁶Customs are relevant for transfer pricing in relation to issues of valuation.

there is a need to ensure that the framework of thresholds, deterrence mechanisms and penalties is effective and up to date; and

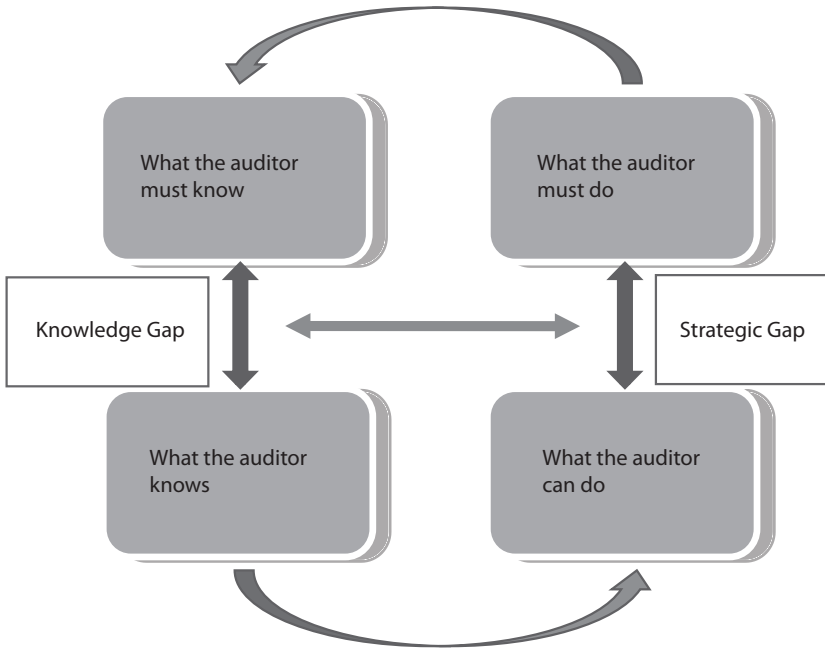
- Utilizing the experience of the administration in taxpayer service, education and enforcement, and feedback from competent authorities in improving legislation or implementing regulations;
- Cross-secondment of tax administrators and policy makers to each other's teams. This will help ensure that administration officials understand the policy making process and the objectives of the legislation, and 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 holiday policies that may affect transfer pricing and other aspects of tax administration; and
- A recognition that policy makers should not be limited in their training to economic effects of investment; tax policy should be incorporated into the training. Conversely, tax officials should also recognise the importance of investment to development and the importance of, for example, seeking to avoid double taxation in accordance with applicable law.

4.3. Assessing Current Capabilities and Gaps to be Filled

4.3.1. 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.

4.3.2. In addressing the issue of developing transfer pricing capability, it is important, first of all, to determine the actual level of existing knowledge and the best organizational approach. The focus in this Manual is on countries with little or no existing experience in transfer pricing, so that 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 4.1:⁴⁷

Figure 4.1: Audit Process



4.3.3. Factors to consider when assessing the level of development/capability of the tax administration include:

⁴⁷Michael Zack, “Developing a Knowledge Strategy: Epilogue”, in *The Strategic Management of Intellectual Capital and Organizational Knowledge*, Nick Bontis and Chun Wei Choo, eds. (Oxford, Oxford University Press, 2002).

- Levels of education and expertise;
- The legal environment (as addressed in Chapter 3) including the characteristics of the transfer pricing legislation and responsibilities for and the scope of regulations;
- Networks of comprehensive bilateral tax treaties including articles relating to Associated Enterprises (usually Article 9), the Mutual Agreement Procedure (usually Article 25) and Exchange of Information (usually Article 26). Additionally, any more limited 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 administration; and
- Availability of information technology systems that allow for the most effective strategies to encourage compliance, develop and support audit strategies and facilitate collection and litigation where necessary, as well as those skilled in using them.

4.4. Developing the Mission, the Vision and the Culture of the Unit

4.4.1. Objectives

4.4.1.1. 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 advisors. Often this is put in terms of developing a “mission” representing what the unit will do in its daily operations and a “vision” representing what an ideal future will look like when the unit carries out its mission properly. Many tax administrations also have a “Taxpayer’s Charters” which reflects what taxpayers can expect from the administration, and what is expected from them in the relationship.

4.4.1.2. Documents reflecting the mission and the vision should become part of the culture and be “lived out” by the unit on a daily basis 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 conversations with stakeholders. This could usefully draw upon the experience of other countries though it must be tailored to your 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.

4.4.1.3. 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 resources needed to meet the objectives of the unit and encourage the best use of such resources.

4.4.2. Client/Taxpayer Orientation

4.4.2.1. A central consideration to be borne in mind is that a transfer pricing unit will have important taxpayer service and education functions as well as a central enforcement function. These functions 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 measures on the greatest risk areas (in particular, those who have no intention of complying with their obligations).

4.4.2.2. 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 inevitably 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 negative view of a country's investment climate, deterring potential investors.

4.4.2.3. On the other hand, increased focus on transfer pricing issues will inevitably lead to some disputes with MNEs and the possibility of double taxation. 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) being subject to tax in your jurisdiction. This is an increasingly common issue in transfer pricing and tax administrations need to devote resources to avoiding unnecessary differences. They need to avoid, where possible, that those differences lead to a dispute and need to deal with formal dispute procedures as expeditiously and effectively as possible when they cannot be avoided.

4.4.2.4. 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 1; see also Chapter 3, Paragraph 3.11. and Chapter 9. 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 authorities under tax treaties, and policy makers to avoid unnecessary adjustments in tax assessments.

4.4.2.5. Engagement with taxpayers, tax advisors and peak representative bodies is necessary to understand the transfer pricing system 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.

4.4.2.6. There is a need for considerable early investment in taxpayer education. The tax administration also needs to ensure professional and effective relationships with taxpayers as an element of taxpayer service. This is an area where the experience of other similarly placed administrations is likely to be especially helpful.

4.4.2.7. Overall, there needs to be a sustained commitment to this part of the "set up process", which is designed to maximize compliance and to assist in risk management (by helping differentiate non-compliance due to lack of understanding from more deliberate and therefore systemically risky, non-compliance). A fair amount of institutional patience and sustained commitment is required if the transfer pricing regime is to fully meet its medium to longer term goals.

4.4.2.8. Some specific steps through which this can be achieved by tax administrators include:

- Knowing taxpayers and their commercial environment, as well as their main issues and concerns, and having in place a continuous dialogue with taxpayers, tax professionals, their associations or peak representative bodies on tax issues;
- Being reasonable and proportionate in actions, and open and transparent with taxpayers;
- Being responsive to requests;
- Extensive and clear taxpayer education, including making available to taxpayers tax guidance notes, information circulars and other guidance on interpretation of tax laws to avoid misunderstandings, confusion and surprises to those willing to meet their obligations;
- An informative and easy to navigate Internet presence that is regularly tested and kept under review for its user-friendliness and relevance;
- Seeking to avoid disputes arising unnecessarily but also setting up clear and fair systems for addressing such disputes that do not unfairly deter taxpayers from pursuing legitimate disputes; and
- Advance rulings on specific issues of taxpayers.

4.4.2.9. Steps that could be encouraged among taxpayers and their advisors include:

- Being transparent and open about their risks, including by 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;⁴⁸

⁴⁸The issue of whether to institute an APA programme is a complex one, which is addressed in Chapter 9 of this Manual; see also the relevant discussion at Chapter 3, Paragraph 3.10. 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 taxpayers likely to be in broad compliance.

- Making their transfer pricing policy available to the tax administration;
- Recognizing the resource limitations on the side of the administration and not “playing games” to tie up those resources unnecessarily to the disadvantage of the administration and other taxpayers; and
- Complying with the requirements of the bilateral double taxation 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.

4.4.3. The Enforcement Approach: Risk-Based Approach to Compliance

4.4.3.1. A “risk management” approach to the unit’s work is recommended; this is true for the tax administration as a whole, but particularly when dealing with a new regime involving the complex and resource-intensive issues of transfer pricing. This means having robust processes in place for:

- Identifying transfer pricing risks;
- Analysing them (including ranking them in terms of their likelihood 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 if taxpayers are not seen as meeting their tax obligations also need also to be considered.

4.4.3.2. Ongoing issues of risk assessment and management are considered in more detail at Chapter 8 of this Manual. In setting up a transfer pricing unit, however, there is an important role for officers attuned to the organization’s approach to risk management and able to implement it systematically for a new area and keep it under review. Consistent risk management strategies will often be developed in conjunction with other areas of the administration, such as those

dealing with tax treaties or thin capitalization, or those clustered around relevant industries or, in offices differentiated based on the size of a taxpayer.

4.4.3.3. As part of this risk management approach, even developed countries with long established transfer pricing regimes and administrations tend in practice to have criteria that define their areas of greatest or least current focus. This often includes thresholds below which they would generally not audit or adjust a controlled transaction for transfer pricing purposes, especially in relation to small and medium sized enterprises or for transactions below certain values.⁴⁹

4.4.3.4. The criteria referred to above will have to be assessed for each country in the light of its own circumstances, and will have to be kept under review to make sure these criteria are not 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 taxpayer’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 ;
- 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.

⁴⁹See for example OECD, “Multi-Country Analysis of Existing Transfer Pricing Simplification Measures” at page 22.

4.5. Organizational Structure for the Transfer Pricing Unit

4.5.1. 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 transfer pricing units by industry or geography. Each has advantages and disadvantages, as follows.

4.5.2. Centralized Model

- **Advantages:** coordination and adjustments to the transfer pricing approach are made easier in the start-up phase; knowledge is built up quickly; the model is in tune with a centralizing tendency in tax administrations (driven in part by the desire for all-encompassing technological developments and compliance strategies); there are clearer lines of authority and communication within the unit; and communications with other areas tend to be more coordinated.
- **Disadvantages:** there is a risk of being in an “ivory tower”—out of touch with realities on the ground; and a risk that over-centralization may reduce transparency and create opportunities for mismanagement and corruption. As transfer pricing experts will need, in any case, to work with experts from outside that group, such as people with various auditing skills, and more general tax auditors with some transfer pricing experience, it is at the very least important to guard against such an “ivory tower” mentality (and being perceived as such) and ensure frequent interactions and exchanges of ideas and even personnel between such groups.

4.5.3. Decentralized Model

- **Advantages:** there are shorter lines of communication with tax inspectors; an easy diffusion of knowledge; combined industry 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 coordination. Such coordination problems may lead to inconsistencies, lack of experience sharing and issues “falling between gaps”; and some taxpayers may take advantage of a lack of coordination by, for example, “picking and choosing” who they approach for rulings.

4.5.4. Whatever model is followed, it is important to have a clear and coordinated approach to transfer pricing issues and their possible solutions, especially as MNEs will generally be far more familiar with transfer pricing issues than individual tax officers in a start-up unit. It is impossible to immediately bring the tax administration to a high level of knowledge in all relevant areas, especially when having to deal with many different industries. Measures need to be put in place to ensure good working relations with tax officials who are experts in particular industries, and tax officials in the various regions where transfer pricing issues may arise, including by regular meetings and formal “contact” points on both sides. This will help ensure the best realistic capability is achieved as soon as possible in terms of educating taxpayers and the administration on transfer pricing, responding to taxpayer requests, identifying compliance issues and their links to other tax issues, and addressing those issues.

4.5.5. It is very important to bear in mind the taxpayer service aspect of the work: the taxpayer should be able to go to a “one-stop” contact point to deal with all issues relating to transfer pricing. That contact point should in turn be responsible for the internal coordination, rather than the taxpayer in effect being forced to act as coordinating agent for the administration. This also helps to promote a broader consistency and coherence within the administration.

4.5.6. The benefits of a “one stop” contact point is also one reason why many administrations have Large Taxpayer Offices (LTO) often with specific industry contact points, to handle relationships with MNEs and other large taxpayers, especially in key sectors of the economy, such as resource extraction. These offices can respond in

an integrated fashion to diverse issues across different subject areas (for example: income tax, VAT and resource royalties) as well as issues of particular importance for such taxpayers such as transfer pricing and thin capitalization. They usually have auditing, registration, tax accounting, collections, and taxpayer service roles and are sometimes seen as especially useful when implementing new approaches, including major policy or administrative reforms such as self-assessment or computer modernization of the tax office as an “incubator” for change elsewhere.

4.5.7. In a monitoring and intelligence gathering sense, this sort of structural approach can also enable more proactive analysis and action to deal quickly with emerging issues, such as unexpected falls in revenue from key industries or segment. Such falls may merely reflect economic conditions but could, alternatively, reflect new compliance risks, such as a rise in “treaty shopping”. Finally, if reform of the administration as a whole is likely to 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 the revenue while preserving relationships with taxpayers. This experience may also provide lessons that can be applied to the reform of the administration more generally.

4.5.8. Many countries adopt a highly centralized model for their transfer pricing unit at start-up. This reflects the importance of coordination and uniform approaches at that time; it also recognizes that a transfer pricing unit is not designed to have a specific lifespan but rather will become a permanent part of the tax administration’s structure. Several models can be used to take transfer pricing capability further after this start-up phase. It is possible to create teams for every region that exclusively deal with transfer pricing cases, for example. National coordination is then achieved by placing team members of each region on a rotation basis to work together and discuss the latest developments in transfer pricing.

4.5.9. Another model is to make all corporate income tax inspectors 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.

4.5.10. As noted above, some countries also have a separate office dealing with MNEs because of their specific characteristics, their relevance in terms of investment and tax revenue they may generate and the related tax issues that are of special importance. Such an office can be organized on a national level or within the regions, depending on the number of MNEs that are active in the country. As noted above, this unit should as far as possible act as a central contact point (or “one-stop shop”) for responses on MNE issues and it will therefore need to contain transfer pricing expertise or at the very least work especially closely with the transfer pricing unit.

4.6. Building Team Capability

4.6.1. General Human Resource Management Issues

4.6.1.1. 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 particular country. As with most changes there are potential advantages and disadvantages. While the human resources management strategy for the unit needs to be integrated 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 mutually 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 importance of avoiding double taxation) and understand the drivers and environment of business, yet believe not only in the crucial importance of collecting the country’s appropriate tax take but also in the necessity of public

confidence in the integrity of the system and in their actions as tax officials;

- Internationally focused officers (including those familiar with the languages most used by international business) who meet routine business needs but are proactive, creative and adaptive to new ideas and challenges, seeing change as an opportunity;
- Officers who are keen to develop and to explore the most efficient and effective ways of doing their work and are patient in dealing with the large demands, complexity and often slow progress of transfer pricing cases rather than seeking to “cut corners”;
- A strategy for the identification and development of managers who are respected, have integrity and can motivate staff and help them share the vision of the unit and the organization;
- Recognizing that not all will want to be, or be suitable as, managers. 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 encourage ways of analysing and reaching conclusions; and
- Clear career prospects and incentives (such as learning opportunities and secondments) for successful officers, based on performance assessments that are fair and 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 unjustified 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.

4.6.1.2. Practice has shown two particular human resources-related risks at this stage. First, there is the possibility of resentment against those involved with transfer pricing policy and administration by others in more “established” areas. Because it is new, people within the organization do not always know exactly what it is about and feel uncertain 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 “outsiders” and “upstarts” who have not “paid their dues”. The interrelationship and equal importance of different aspects of the organization’s mission and vision need to be emphasized and “buy-in” established with other parts of the organization. However, it has to be stressed that building up capability in this area will involve new approaches and bringing in some fresh perspectives and new skill-sets. The unit should not have a sense of superiority as part of its culture, but rather a sense of the importance of its work and of the opportunities to pursue broader organizational goals while furthering personal development.

4.6.1.3. The link can be established between an effective transfer pricing response and a more effective response by the organization to more general tax issues 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 negotiation and administration.

4.6.1.4. There is, on the other hand, a risk that employees from the tax administration will become overly enthusiastic about transfer pricing as a “panacea” — a solution to all problems — and may accordingly 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 important

to manage this process, and ensure that any proposed transfer pricing adjustment is justified on purely transfer pricing grounds; it is also important to show that the discretion implicit in such an inexact situation is properly exercised. This involves integrity issues and it is important that decisions taken having major financial impact are appropriately checked and “signed off” in a way that not only ensures (as far as possible) that they are made for the right reasons and consistently with the treatment of other taxpayers, but that they are also seen as doing so.

4.6.2. Competences/Skill Sets Needed by the Unit: Putting Together the Best Team

4.6.2.1. Recognizing the many aspects of transfer pricing and that the unit will have educative and taxpayer service functions as well as an enforcement role, a transfer pricing unit should ideally include, or have ready access to, the following 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;
- Business Process Experts (using information technology to evaluate, 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 problems, explain complex issues in terms that are readily understandable and act “diplomatically” with a view to longer-term productive relationships.

4.6.2.2. These various skillsets should be bound together not just by technical knowledge and willingness to learn, but also 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.

4.6.2.3. 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 international 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. Staff with a background in accounting have, for example, often been regarded as easy to train in this area as they are often enthusiastic about specializing in this field, but similar enthusiasm can be found in those with other skill sets. Others, such as lawyers and economists have special skills in dealing with the often complex law and economics of transfer pricing cases, and one of the challenges in this area is having all those skills working together effectively.

4.6.2.4. At the initial stages, specific transfer pricing expertise may not be generally available in the country (or at least within the administration) and will in large part have to be developed. At a later stage expertise from outside may be encouraged to join the tax administration by higher than usual salaries (although that can create resentment among other staff) as well as non-financial incentives such as the ability to work on the governmental “side”, perhaps with greater policy or legislative exposure and improved lifestyle (by creating a more balanced work environment for those with children, for example). Developed countries may be willing to place one of their experts in a developing country as a component of Official Development Assistance (ODA) or to sponsor a promising officer from a developing country in a placement within their administration.

4.6.2.5. 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 effective system of recording and filing relevant transfer pricing opinions and material relating to particular cases. In any case, such interplay of “cultures” between the administration and the business sector over time can be useful for each of these entities; it helps each to understand what drives the other and what the expectations are.

4.6.2.6. 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 possible outcomes in transfer pricing and room for discussion. Skills that help make these discussions as professional and effective as possible are an important component of a successful transfer pricing unit.

4.6.2.7. 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 pricing issues later moving to the private sector. The best way to deal with these issues is by having discussions with MNEs in teams, and ensuring that records are kept of those discussions. The records should be internally reviewable to ensure that the proper policies and practices have been followed and to make sure a consistent approach has been adopted between taxpayers. This helps to ensure that working arrangements are transparent, open and incorporate built-in checks and balances that will reduce the risk of temptation on both sides. It is also important to recognize that officers should be given protection from false accusations against their integrity, which may reduce their willingness to approach each case fairly and impartially. The checks and balances should be designed to support officers acting properly and 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.

4.6.2.8. Regular internal audits of the members of the unit can form part of the system of checks and balances. These audits could include reviews of quality, consistency and timeliness of decisions as well as, possibly, of personal assets of individual officers (such as by

declarations of assets and interests and checks as to their accuracy). If resources allow, some form of double-checking of audits including rotation of fresh auditors into such roles can prove to be useful in this respect.

4.6.2.9. 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, integrity, sound technical standards and effective case management. This can also, to some extent, form part of the on-the-job training. Those undertaking the review should ideally comprise not just officers from the unit, but also from other relevant areas. The group could include officers dealing with the type of business or industry (such as officers from the Large Taxpayer Office if it is separate), intelligence officers, officers from the economic unit (if there is a separate pool of economists working on transfer pricing issues but not part of the transfer pricing unit — an issue discussed below) tax treaty experts and those dealing with potentially related areas, such as thin capitalization.

4.6.2.10. 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 knowledge and business and industry knowledge. It is however also important to understand international taxation issues and the tax rationale underlying relevant transactions.

4.6.2.11. 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 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.

4.6.2.12. The advantages of a separate pool of economists, on the other hand, are that greater “quality control” can be exerted, especially in the start-up phase, over the consistency of economic analyses.

Further, economists in a new area can discuss new issues and learn from each other more easily. As with any specialist skill, having economists working in groups at the start-up phase may also be seen as promoting integrity and an “aligned” and consistent approach to the issues that arise.

4.6.2.13. 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.

4.6.3. Training

4.6.3.1. In some countries the educational system provides a steady supply of accountants, auditors, economists and lawyers from which the tax administration can draw. In other countries the situation is more difficult either because the formal educational system does not produce enough qualified graduates or because there is more competition, especially on salaries, from the private sector. This will affect the type of training required and it is of the utmost importance to assess the knowledge, capabilities and competencies of officers.

4.6.3.2. 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 without a context, and that context must be the short, medium and longer term objectives of the unit, so it is essentially a “gap assessment”. Such an assessment considers what needs to be done to go from the current capability to the desired future capability. It will address how to achieve the objectives at various stages of the life of the unit and under various scenarios.

4.6.3.3. This assessment should be followed by setting up a training programme to operationalize its recommendations. For a start it is good to first have a group of experts with accountancy and legal backgrounds. The pioneer group to be trained should consist of senior tax officials from the administration (and preferably also from the policy making area). They are the pioneers and champions who should instil awareness in their colleagues of the importance of a transfer

pricing capability. They will organize lectures and in-house seminars to train those officials who will become the next group of experts and to increase their skills and knowledge.

4.6.3.4. Specialist courses will be an important aspect of the training programme. As transfer pricing is a highly specialized expertise, 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, but take it forward, and to 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 satisfaction) by undertaking targeted training. International development agencies, 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.

4.6.3.5. 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 authority, in each region with the right skills and make them responsible for further training as well as operational activities. However, the disadvantage is that other tax officials may resent this group, especially if they are given financial and non-financial incentives, as sometimes happens. In this initial period it is expected that only a few cases will be dealt with; 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 countries. The policy makers will see what the major issues are and have early warning of issues on the horizon that may need swift but considered policy responses.

4.6.3.6. In the meantime the same approach can be adopted to train the next generation of specialists. The ultimate aim is that all corporate income tax specialists are able to handle at least some aspects of

transfer pricing cases. Before that is achieved, as large as possible a group of those dealing with MNEs need to be able to at least *identify* cases where there is a transfer pricing issue, for further consideration by specialist transfer pricing experts. Even though they may not know all the answers, they will be able to identify issues and will know where to go to find the answers. Additionally, their involvement in this process will help enhance their knowledge.

4.6.3.7. Training should not be merely on transfer pricing issues, of course, as training in management, negotiation and inter-personal/relationship building skills will also be very important. So too will be knowledge management, project planning, database and other IT skills. Ethics training can be helpful in ensuring that officers are aware of ethical considerations in their new role as well as more formal legal rules of conduct, and of the way in which these interact (especially as to the exercise of discretions).

4.6.4. Research Materials/Databases

4.6.4.1. The unit should have access to basic transfer pricing books and, if finances allows, a subscription to a dedicated transfer pricing journal dealing with current issues of interest to countries. As noted elsewhere in this Manual, databases are used by administrations, taxpayers and their advisers when searching for and evaluating possible comparables. They can be used to analyse materials such as:

- Company annual reports;
- Auditor's reports;
- Profit and loss accounts;
- Notes to the accounts;
- Balance sheets;
- Materials indicating the nature of related party transactions;
- Materials indicating the nature of the business; and
- Materials indicating profit margins.

Such databases can provide access to private company data not on the public record, as well as public company data. They can also be helpful in systematizing how the data is used, in keeping a record of what is looked at, who has looked at it, and what decisions have been taken,

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.

4.6.4.2. Private databases tend to be expensive, although sometimes an introductory price can be negotiated that is much lower than the usual pricing. It cannot of course be presumed that that low price will always be offered. One caution is that relevant data is not available for many developing countries, and the relevance of databases based on other markets and environments has to be carefully considered—adjusting the data to make it relevant to your cases may itself be very resource-intensive. That issue is addressed in more detail in Chapter 5 on Comparability Analysis.

4.6.4.3. 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.

4.6.5. Information Strategies

4.6.5.1. The unit will need to have access to the necessary information technology hardware and software to enable them to deal with the complexity and volume of transfer pricing-related information, with necessary security measures in view of the commercially sensitive taxpayer information that will be held.

4.6.5.2. Information strategies will be needed to deal with such technology and the way information is held. Taxpayer files need to be held securely but centrally, so that it is clear what has been requested of taxpayers and when, as well as what has been received and when. It should also be clear when materials have been accessed and by whom among the authorized persons, as well as whether information has been downloaded. A data back-up policy will be needed, with measures to ensure that no data are lost if there is a corrupted or lost back-up (such as duplicate backups held in different locations, with the immediately previous backups being retained also). It is important that documents are not lost or destroyed and that the large volume of paperwork that is a characteristic of transfer pricing cases is not overwhelming, but is securely held. The possibility of litigation on transfer pricing issues must always be borne in mind, even though it should be seen by both sides as a last resort.

4.6.5.3. Some countries require material to be provided in electronic form, and others require or encourage an index system for the documents provided and a description of the record-keeping system used. If such information is electronically searchable then, subject to the availability of the necessary software and skills, there are potentially great resource savings in dealing with often very large files, speedier response times, and less chance of information being lost. The cost to taxpayers of providing material in certain forms should always be considered in deciding what should be required under relevant legislation or regulations

4.7. Effective and Efficient Business Processes

4.7.1. Streamlining and simplification of procedures is part of tax administration reform to reduce compliance costs for taxpayers as well as collection costs for administrations. Any such processes being considered in a country should be internalized as part of setting up any transfer pricing capability. This is especially the case because overcomplicated procedures can lead to more informal processes, short-cuts or discretions being used with no legal basis and/or with inconsistency in application between taxpayers. They thus create a severe risk to the integrity of the system as well as increasing compliance and collection costs.

4.7.2. A useful approach is to consider what other administrations do in similar circumstances, especially administrations in the same region, and to follow that guidance unless there are reasons why such guidance is not appropriate after a close examination of the options and the engagement of stakeholders. This approach of looking to what is being done elsewhere as a first point of reference will reduce compliance costs for taxpayers and contribute to a positive investment climate without impacting on the ability to deal with enforcement issues. In fact it should enhance that ability, as the user can draw upon the practice of other administrations and probably deal with those administrations more effectively because of common starting points.

4.7.3. There will generally be discretions provided in the legislation 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.

4.7.4. Owing to the amounts of money at stake in many transfer pricing cases, and perhaps the fact that government transfer pricing experts often eventually leave for the private sector, strong checks and balances are required when decisions are made affecting taxpayer liabilities to tax. On the reverse side, it needs to be clear that the unit is not anti-business, but recognizes the way business inherently operates, the need to follow the law, as well as the need to recognize the duty to provide service to taxpayers and exercise strong enforcement approaches only where warranted and on a fair basis.

4.8. Application of the Above Considerations in Implementing a Transfer Pricing Unit and Enhancing Capability

4.8.1. 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 implementing 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 indicators for cross-border transactions. In a start-up phase many countries focus on their main industries (such as mining, pharmaceuticals, telecommunications, breweries and automobiles), and usually on the larger players in the industry in particular;
- Good, professional relations with business. Acceptance and understanding of the policy will reduce compliance and

collection costs. Meetings with all stakeholders will help in effectively building and improving transfer pricing policy and capability. This also means 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 emerging issues. This allows more focussed and efficient guidance and enforcement action;

- Understanding what other countries have done at a similar stage and also what they are doing now and where that represents an evolution. This can include:

Inviting representatives from other countries with a history of transfer pricing to give their views and share their experiences;

Reciprocal placements with countries that offer useful experience and which 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, and why the other country willing to host a visit is the right country to learn from, its expected impact and flow-on effects; and

Seeking support from donors to arrange visits to such countries, with rigorous and strategic selection of participants, a strong work programme and an obligation to report on the outcomes and lessons learned. All this will help to ensure that it is not perceived, including by the other country or potential donors, as a "holiday" for participants. This can have important additional benefits in personnel management as those who are most open to learning new things and are judged likely to stay with the organization for some time and take transfer pricing technical or managerial leadership roles may be offered such exposure;

- An ability to define, with policy makers and administrators involved in the process, the important areas of focus bearing in mind:
 - The main characteristics of the country's industries, e.g. manufacturers or distribution activities;

- The main kinds of cases contained in the workload of the tax administration;
- The main types of activities to start with in developing policies, recognizing the need for policy to be soundly based in reality; and
- Practical case studies that can provide input for policy-making and a focus for discussing administration issues.

4.8.2. After starting the transfer pricing unit, areas of focus will evolve depending on factors including the stage of development of the transfer pricing policy and the administration. In the first years it is often considered helpful to focus on less complicated activities such as contract manufacturing, 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 journey 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.

4.8.3. Assessing Effectiveness and Fine Tuning

4.8.3.1. It is best to set up a system of monitoring based on a performance measurement framework that establishes performance indicators and key outputs. While it is important not to overload staff, who will undoubtedly be very stretched for time and resources, possible areas of monitoring (some by raw data, some by questionnaires and interviews) include:

- The time schedules involved in transfer pricing disputes;
- Yield from risk-based audits and the percentage of yielding audits;
- Adjustments in tax assessment;
- Ability to respond quickly to emerging issues — including measurable deterrent effects on taxpayer behaviour;
- 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 prior set customer service standards;
- Total administration costs of the unit as a percentage of gross collection;
- Improvements made to process, as well as legislative improvements that have arisen out of the areas of work;
- Training undertaken and given, and the measurable impact; and
- Evidence of sharing best practice with other government departments and other tax authorities as part of a continuous improvement strategy.

4.8.3.2. As with any such measurement process, if data that is collected is not being used by management to assess progress, the reasons should be considered and the data requirements modified or the use of the data improved. In other words, the process of review should itself be reviewed for effectiveness on a regular basis.

4.9. Country Examples of Capacity Building in Transfer Pricing

4.9.1. **Japan** started its transfer pricing administration with a small unit in the late 1980s. Once the National Tax Agency (NTA) identified the rapidly increasing needs for transfer pricing management, it expanded a nationwide training course for international taxation step-by-step, now reaching approximately 100 trainees every year; and also reorganized and gradually expanded the national and regional examination division. Currently the headquarters has transfer pricing sections and the MAP office, while the four major regional bureaus have special divisions for transfer pricing (including two divisions specializing in APAs). Although some essential documentation concerning transfer pricing is required by statute to be translated into Japanese, the transfer pricing specialists are generally equipped with sufficient language skills to conduct examinations of the original accounting books, documents, etc in English.

4.9.2. In **India** capacity building has taken place mainly through on-the-job-training. The Directorate of Transfer Pricing has expanded given that the numbers of cases being referred for audit are increasing

annually since 2004, when the Directorate was set up. The National Academy of Direct Taxes, the apex body responsible for training, has been conducting specialized training for officers. The Directorate has organized seminars and conferences for experience sharing by officers engaged in audit and for capacity building of officers joining the Directorate.

4.9.3. In **Malaysia**, the Inland Revenue Board Malaysia (IRBM) responded to the rise in issues pertaining to cross-border related party transactions in audit and investigation cases by setting up the transfer pricing audit unit, known as the Special Audit Unit, on 1 August 2003.

4.9.3.1. 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 pricing cases with the assistance of the Special Audit Unit. By 2007, transfer pricing cases became increasingly challenging and the Special Audit Unit grew 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 standardized approach.

4.9.3.2. 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, efforts towards centralizing transfer pricing activities was put forward 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 pertaining to regulations and procedures;

- Multinational Audit Division (eight auditors), which conducts audit visits;
- Compliance Audit Division (four auditors), which monitors compliance of cases previously audited; and
- Advance Pricing Arrangements Division (one auditor) which deals with the application and processing of APA including bilateral and multilateral APAs.

4.9.3.3. Auditors were sent to various training events both in and outside of 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 community more generally.

Chapter 5

COMPARABILITY ANALYSIS

5.1. Rationale for Comparability Analysis

5.1.1. The term “comparability analysis” is used to designate two distinct but related analytical steps:

1. An understanding of
 - (a) The economically significant characteristics of the controlled transaction, i.e. the transaction between associated enterprises, and
 - (b) The respective roles of the parties to the controlled transaction. This is generally performed through an examination of five “comparability factors”, see further Paragraph 5.1.6.
2. A comparison between the conditions of the controlled transaction and those in uncontrolled transactions (i.e. transactions between independent enterprises) taking place in comparable circumstances. The latter are often referred to as “comparable uncontrolled transactions” or “comparables”.

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

5.1.3. A practical difficulty in applying the arm’s length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Where independent enterprises do not undertake transactions of the type entered into by associated enterprises, the arm’s length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises. 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.

5.1.4. 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 having comparable 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 5.1.5. below. In other instances where no comparables are found for a controlled transaction between associated enterprises, it may become necessary to use a transfer pricing method that does not depend on comparables (see further Chapter 6). It may also be necessary to examine the economic substance of the controlled transaction to determine whether its conditions are such that it might be expected to have been agreed between independent parties in similar circumstances — in the absence of evidence of what independent parties have actually done in similar circumstances.

5.1.5. A controlled and an uncontrolled transaction are regarded as comparable if the economically relevant characteristics of the two transactions and the circumstances surrounding them are sufficiently similar to provide a reliable measure of an arm's length result. It is recognized that in reality two transactions are seldom completely alike and in this imperfect world, perfect comparables are often not available. It is therefore necessary to use a practical approach to establish the degree of comparability between controlled and uncontrolled transactions. To be comparable does not mean that the two transactions are necessarily identical, but instead means that either none of the differences between them could materially affect the arm's length price or profit or, where such material differences exist, that reasonably 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 ascertained with sufficient accuracy to improve the reliability of the results.

5.1.6. 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 materially affect prices or profits and the adjustment that can be made to account for differences. 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 “functional analysis”;
- Contractual terms;
- Economic circumstances; and
- Business strategies pursued.

5.1.7. Obviously, as the degree of comparability increases, the number and extent of potential differences that could render the analysis inaccurate necessarily decreases. Also, in general, while adjustments 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 comparability analysis.

5.1.8. The type and attributes of available comparables in a given situation typically determine the most appropriate transfer pricing method. For further information see Chapter 1, Paragraph 1.5. and Chapter 6. In general, closely comparable 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 analyses of the two distributors would be comparable. See further Chapter 6.

5.1.9. Practical guidance is needed for cases without sufficient comparables. There seems 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 databases; 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 determination 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).

5.1.10. The OECD Transfer Pricing Guidelines points 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.⁵⁰ 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.

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

5.2. Comparability Analysis Process

A typical approach that can be followed while performing a comparability analysis is outlined below. The steps below are by no means exhaustive but rather suggest an outline based upon which a comparability 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:

⁵⁰OECD, "Transfer Pricing Guidelines for Multinational Enterprises" at Paragraph 3.35 and 3.38.

- Understanding the economically significant characteristics of the industry, taxpayer's business and controlled transactions
 - Gathering of basic information about the taxpayer
 - Transaction analysis
 - Evaluation of separate and/or combined transactions;
- Examination of comparability factors of the controlled transaction
 - Characteristics of the property or service transferred
 - Functional analysis of the controlled transaction under examination
 - Contractual terms of the transaction
 - Economic circumstances of the transaction
 - Business strategies of the parties;
- Selecting the tested party(ies) (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.

5.3. Comparability Analysis in Operation

5.3.1. Understanding the Economically Significant Characteristics of the Industry, Business and Controlled Transactions

Gathering of basic information about the taxpayer

5.3.1.1. An essential first step to enable effective transfer pricing analysis is the collection of background information about the taxpayer to understand its business operations and activities. This fact-finding process should include identification of associated enterprises involved

in the controlled transaction, the taxpayer's cross-border controlled transactions and gathering information about relevant cross-border controlled transactions (nature of products/services transferred, type of intangibles used, value thereof, terms and conditions, etc).

5.3.1.2. An analysis should be performed of the taxpayer's circumstances 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.

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

Transaction analysis

5.3.1.4. The arm's length price must be established in relation to transactions actually undertaken. Tax authorities should not substitute other transactions in the place of those that have actually happened and should not disregard those transactions actually undertaken. In exceptional circumstances such as where the economic substance of the transaction differs from its form, or where the arrangements viewed in their totality are not commercially rational and where reliance on them would in practice impede the tax administration from determining an appropriate transfer price. In general, restructuring of transactions 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 the transactions are structured. The ability of tax authorities to restructure 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 3 and 4.

Evaluation of separate and combined transactions

5.3.1.5. An important aspect of transfer pricing analysis is whether this analysis has to be carried out with respect to a taxpayer's individual international controlled transactions or to a group of international controlled transactions having a close economic nexus.

5.3.1.6. The transfer pricing analysis should ideally be made on a transaction-by-transaction basis. However, there are cases where separate transactions are so closely linked that such an approach would not lead to a reliable result. Where transactions are so closely interrelated or continuous that application of the arm's length principle on a transaction-by-transaction basis would become unreliable or cumbersome, transactions are often aggregated for the purposes of the analysis.

5.3.1.7. 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 separate from individual transactions.

5.3.1.8. 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 transfer price. In certain cases it may be more reliable to allocate the price to the elements of the composite contract or package deal.

5.3.1.9. "Aggregation" issues also arise when looking at potential comparables. Since third party information is not often available at the transaction level, entity level information is frequently used in practice

when looking at external comparables (e.g. in the absence of reliable internal comparables; “external comparable” and “internal comparable” are defined in Paragraph 5.3.4.1 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 pricing method to the facts in that particular case.

5.3.2. Examination of Comparability Factors of the Controlled Transaction

Characteristics of the property or service transferred

5.3.2.1. With the background noted above, an important step is to analyse the relevant characteristics of the property or service transferred. Property, whether tangible or intangible, as well as services, may have differing characteristics which may lead to a difference 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, reliability, 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 commercial exploitation (marketing intangibles) as opposed to patents and know-how (trade intangibles).

Functional analysis

5.3.2.2. 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.

5.3.2.3. Functional analysis is the cornerstone of any transfer pricing 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. The more valuable those functions, assets and 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 functions, assets and risks between the parties.

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

5.3.2.5. The functional analysis is important because the expected return of the entities involved in a transaction depends on the importance of the functions performed, the degree of risks undertaken and the nature and value of assets employed. Generally, the more valuable the functions performed, assets employed and 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.

5.3.2.6. 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 technology is owned by an associated enterprise ABC & Co; and
2. Distribution by A Co of products imported from an associated 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.

A Co is a company incorporated and registered under the laws of Country A. 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, distribution 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 technology, 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 elec-

tricity revenue and demand, thereby limiting or eliminating revenue losses. TECHNO A™ technology was developed in Country A by A Co. TECHNO A™ technology measures electricity flow using digital and microprocessor based techniques and processes the measurements into useful information. Use of TECHNO A™ technology has major advantages in the design and manufacture of meters.

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 technologies so as to achieve further efficiencies. This would mean that dependence on outside sources for technologies would be reduced in the future and cost-savings could be achieved. Also B Co has penetrated the market in the territory of Country B by incurring huge marketing expenditure to establish its own marketing intangibles. These are separate from the intangibles of 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 represented by the following type of table:

Table 5.1: Qualitative Assessment of Intra-Group Transactions

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

These symbols are a tool to summarize key aspects of a functional analysis, 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 subjective. Accordingly, the same set of facts in the hands of two different analysts may not result in identical tick charts. Caution should be used in giving tick charts quantitative significance. For example, three ticks do not reflect three times more value than a single tick. Moreover, all categories in the chart do not have equivalent weight. Accordingly, tick charts should primarily be used as a tool in evaluating qualitative aspects of the analysis, and should not be used mechanically to split profits according to the relative number of ticks.

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

5.3.2.8. Some of the important 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 management services.

5.3.2.9. It should be emphasized that this list is purely indicative; the extent to which each of these functions (or other functions not listed above) is economically significant and contributes to the creation of value depends on the industry and on the taxpayer-specific circumstances. A typical check list is provided in Appendix 1.

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

5.3.2.11. Continuing the example from Paragraph 5.3.2.6, 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 development activities based on the concept developed and offered by it to the users. Product development involves product engineering, designs, development or customization of microprocessors, observance of international standards and national standards for the product etc.
- **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 company 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, commission agents, sales promotion, market research and marketing strategies. Also B Co has developed the market for the new product in the territory of Country B by incurring sizeable marketing expenditure to establish its own marketing intangibles that are separate from the intangibles of 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 outside technologies in future and achieving cost savings;
- **Production scheduling:** The production by B Co is based on orders obtained from domestic utilities. The procurement process for the various raw materials/inputs is based on prudently prepared sales forecasts. The procurement function and the ordering processes are looked after by the “materials department”. Factors like lead time, availability, negotiations, etc are taken into consideration while deciding the party from which a particular raw material/input is to be purchased;
- **Tooling:** The tooling activities in relation to the products to be produced are undertaken by 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 components, manual inspection of placement of the components, computerized soldering of mounted components, manual inspection of the soldering process, mounting of plasma transformed arc components manually, etc;
- **Intelligence loading:** Intelligence loading refers to the process of loading software and other intelligence features on the manufactured meter. 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 performs 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 consignment. The containers are in the form of cartons and pallet packaging. After packaging, products are delivered to domestic utilities;
- **Post sales activities:** Depending on the contracts with the customers, B Co undertakes installation and commissioning activities wherever required under the contracts. It is also responsible for the collection of payments from customers. Contractual and non-contractual product warranties are provided to customers. Any replacement or further activities required pursuant to product performance warranties are also undertaken by 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 management 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 indispensable 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 economic environment surrounding the entity, assess their strategic position within the industry and set targets to achieve their corporate objectives;

- **Finance, accounting, treasury and legal functions:** The management of the respective entity is responsible for managing the finance, treasury, legal and accounting functions. Each entity is also responsible for all local statutory compliance;
- **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 5.2: 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	-	***

5.3.2.12. 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.

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

5.3.2.14. 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 analysis. Adjustment might be required to ensure consistency of accounting standards between the controlled transaction and the comparable. Differences in the use of assets can be eliminated or reduced to a significant extent by making comparability adjustments on account of working capital or capacity utilization.

5.3.2.15. It is also essential to know which entity or entities have the legal ownership of the intangibles. Note that in some cases an enterprise which does not have legal ownership of an intangible may nevertheless be entitled to a share of the returns from its exploitation. Some countries refer to this notion as “economic ownership”. For instance, where an MNE parent has legal ownership of a product trademark or trade name it may have to be determined, depending on the facts and circumstances of the case, whether the subsidiary has “economic ownership” of the associated marketing intangibles that are created, based on the subsidiary’s contribution to a strategy to enhance market share.

5.3.2.16. 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 following 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 improving technologies so as to achieve further efficiencies. This would also reduce dependence on outside sources of technology in the future and achieve cost savings. The department also conducts R&D programmes to support 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 leverages value from these intangibles for continued growth in revenues and profits;
- A Co is the market leader in the development and supply of electronic meters, as well as related software, energy monitoring, billing solutions and payment systems. Over the years the company has amassed a wealth of proprietary technical knowledge. This includes product specifications, designs, the latest manufacturing processes and empirical data on the usage of products by customers in the industry;
- A Co enjoys a reputation for quality products. In the international utility markets, product supplies from interna-

tional players from developed countries are preferred by the customers and utilities as compared to direct product supplies from suppliers located in developing countries. B Co leverages 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 5.3: Summary of Assets Employed

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

Risks Assumed

5.3.2.17. Risk assessment is important in the functional analysis and it should be considered together with the functions and assets. There are two important aspects to risk: how risk is created and which entity bears the risk. Risk in an MNE is created by the ownership, exploitation or use of assets, or by the performance of functions over time. The next question is which entity bears the risk. Risk analysis involves the identification of the economically significant risks that are assumed by each of the parties to the transaction. It is commonly understood that the bearing of economically significant risk is related to the anticipation of a reward.

5.3.2.18. In the open market the greater the economically significant risks assumed by an enterprise the higher the return that it expects, although the actual return may or may not increase depending on the degree to which such risks are realized. Conversely, in a case where such risks undertaken by the enterprise in a transaction are minimal, the return it may expect from such transactions should normally be lower. It would be expected that this would be the case in a controlled transaction that satisfies the arm’s length principle.

5.3.2.19. An illustrative list of risks assumed by the parties to the transaction is provided below, however the relevance of each individual risk factor listed below will depend on the nature of the transaction.

Table 5.4: 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
3. Market risk	a. Development of a market including advertisement and product promotion, etc
	b. Fluctuation in demand and prices
	c. Business cycle risk
	d. Volume risk
	e. Service incentive scheme risk
	f. Asset redundancy risk
4. Collection risk	a. Credit risk
	b. Bad debt risk
5. Entrepreneurial risk	a. Risk of loss associated with capital investment
	b. Single customer risk
	c. Risk of losing human capital intangible
6. General business risk	a. Risk related to ownership of property
	b. Risk associated with the exploitation of a business
	c. Inflation risk
7. Country/regional risk	a. Political risk
	b. Security risk
	c. Regulatory risk
	d. Risk related to government policies

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

5.3.2.21. Risk analysis is important because comparability adjustments may need to be made for differences in risks that are assumed in a controlled transaction as compared to those in an uncontrolled transaction.

5.3.2.22. It is not only necessary to identify the risks but also to identify who bears such risks. The allocation of risks is usually based on the contractual terms between the parties. However, contracts between associated enterprises may not specify the allocation of all the risks. Most of the commonly assigned risks in the contract are controllable risks, for example inventory risk, bad debts, foreign exchange risk etc. Market circumstances, price competition, the supply of raw materials, rises in wages etc are uncontrollable or less controllable risks, which may not be identified in the contract. Volatility in the global market in the last decade has demonstrated that these uncontrollable risks are economically more significant than controllable risks or contractual risks as mentioned above.

5.3.2.23. Even where a written contract is in place, an analysis of the conduct of the parties is critical in order to determine whether the actual allocation of risk conforms to the contractual risk allocation. The allocation of risk under a contract will generally be respected by the tax authorities unless it is not consistent with the economic substance of the transaction. 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.

5.3.2.24. When analysing the economic substance of a transaction, it is necessary to examine whether the conduct of the associated enterprises over time has been consistent with the purported allocation of risk and whether changes in the pattern of behaviour have been matched by changes in the contractual arrangements.

5.3.2.25. In addition, the contractual allocation of risks should be at arm's length. Where there are reasonably reliable comparables evidencing a similar allocation of risks between independent parties, then the allocation of risks between the associated enterprises is regarded as being at arm's length.

5.3.2.26. In the absence of such comparables one relevant, although not determinative, factor that can assist in the determination of whether the allocation of risk is at arm's length is the examination of which party or parties have relatively more control over the risk. In arm's length dealings a party usually bears a greater proportion of the risk from business activities over which it exercises relatively more control. The components which may be considered to help identify the party which has control over the risk may include, when examined in relation to that particular risk:

- Core functions;
- Key responsibilities: formulation of policy, formulation of plan, budget, fixation of goals and targets etc;
- Key decisions: strategic decisions which have greater potential to impact the ability of an entity to generate profit and the amount of profits; and
- Level of individual responsibility for the key decisions. Allocation of power to senior management or a level below depends upon the location of core functions in the country of the MNE or subsidiary, their contribution to core components of the various functions, their authority, their responsibility and the duties included in the employment contract of the MNE or subsidiary.

An examination of which party or parties have relatively more control over the risk is included in the determination of whether the allocation of risk is at arm's length. This can be illustrated by the following examples:

Example 1: Control over Risk by Parent Company

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

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. Company A designs and monitors the MNEs overall research programmes, provides funds needed for R&D activities and controls the annual budget for R&D activities of Companies B and C. The CEO, CFO and other senior management personnel of Companies B and C reside in Countries X and Y and are technically and functionally competent to take decisions and carry out the R&D activities of Company B and C, under the overall direction of Company A. The technical manpower needed for R&D activity and the assets of companies B and C are located in Countries X and Y.

Company A claims that it controls the risk of the R&D activities of its subsidiaries. On inquiry in audit, it is found that the personnel managing the group's R&D activities in Company A in Country Z are technically qualified to take strategic decisions and to monitor the R&D activities of Companies B and C. It is also demonstrated that in fact substantial controls are exercised by the personnel of Company A. 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 strategic decisions required for performing the core functions of R&D.

In this example, while the actual functions of R&D activities are undertaken in Countries X and Y, Company A has demonstrated that it has the capability to control, and actually controls, the risks of unsuccessful R&D activity through its strategic decisions and monitoring activities and through bearing the losses from unsuccessful R&D programmes. Accordingly, Company A bears 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 strategic decisions to perform these core 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. Hence, Companies B and C as well as Company A should be entitled to an appropriate return for their functions and risks.

Example 2: 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 subsidiaries. Company B and C, which are both subsidiaries of Company A, operate R & D centres situated in Country X and Y respectively, having normal tax rates.

Company A, which employs a workforce of ten persons including a CEO, CFO and other senior management, claims that it controls and takes all strategic decisions with regard to the core functions of companies B and C. Company A provides the funds needed for R&D activities and controls the annual budget for such activities of Companies B and C. It also provides technical assistance for registration of patents in Countries X, Y and Z. The CEO, CFO and other senior management personnel of Company B and C reside in Countries X and Y and are technically and functionally competent to take decisions and carry out R&D activities of Company B and C. The technical manpower needed for R&D activity and the R&D related assets of companies B and C are located in Countries X and Y.

Company A claims that it controls the risk of the R&D activities of its subsidiaries. Upon audit it was found that the CEO and CFO and senior management of Company A in Country Z are technically not skilled either to take strategic decisions or to monitor the R&D activities of company B and C. Company A has not furnished any evidence of taking strategic decisions. On the other hand, it was found that the senior management of Companies B and C are taking the important strategic decisions related to the design and direction of the R&D programme and budget. However, Company A has furnished evidence that the funds were actually transferred to its subsidiaries for R&D activities.

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

5.3.2.27. In arm's length transactions, another factor, which is however not determinative, that may influence an independent party's willingness to take on a risk is its anticipated financial capacity at the time when risk is allocated to it. If it is anticipated that the party will not have the capacity to bear the consequences of the risk should it materialize and that it also does not put in place a mechanism to cover the risk, there may be doubt as to whether risk would be assigned to this party at arm's length. It should be noted that the financial capacity to assume the risk is not necessarily the financial capacity to bear the full consequences of the risk materializing (e.g. the full loss). The risk-bearer may have the capacity to protect itself from the consequences of the risk materializing (e.g. by hedging the risk or otherwise). Further, a high level of capitalization by itself does not mean that the highly capitalized party carries higher risk.

5.3.2.28 Beyond the identification of these two relevant factors it is not possible to provide prescriptive criteria that would provide certainty in all situations. The determination that the risk allocation in a controlled transaction is not one that would have been agreed upon between independent parties should therefore be made with care considering the facts and circumstances of each case. It is relevant to mention here that in a multinational enterprise associated entities work together to exert control over the risks of the entire MNE group. Real and precise distribution of risk among the associated enterprises is virtually impossible to achieve, due to the lack of sufficiently detailed information in some cases.

5.3.2.29. Continuing the example from Paragraph 5.3.2.6., it is assumed for the purpose of the example that the following are the risks borne by the respective parties.

Contractual terms of transaction

5.3.2.30. The conduct of the contracting parties is generally a result of the terms of the contract between them. The contractual relationship 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.

Table 5.5: Risks Exposure

Risk Category	Exposure of A Co	Exposure of B Co
Product liability 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 specification given by domestic power utilities. Risks arising from non-conformity with customer specifications or national/international 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 technology scenario, the company needs to continuously upgrade its existing technology and develop new technology. A Co continuously focuses on providing products with contemporary 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 innovative solutions that offer competitive advantages for customers worldwide.	It is assumed that since no significant R&D (except for supporting B Co's business and that of providing technical assistance to its customers) is carried out by B Co, it faces no significant risk on this account.
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 associated with sales are borne by B Co.

Risk Category	Exposure of A Co	Exposure of 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 requisite stock levels for each product including finished goods. However, this risk is mitigated to the extent that components are procured from A Co.
Foreign currency risk	It is assumed that A Co exports technology and components to B Co; hence they are also subjected to appreciation/depreciation of local currency 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 5.6: 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	**	**

5.3.2.31. An important point to note is that associated enterprises may not hold each other fully to the terms of the contract as they have common overarching interests; this contrasts with independent enterprises, who 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 genuine, but when looked at more closely lacks reality, and is not valid under many legal systems) and/or have not been followed in reality.

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

5.3.2.33 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.

5.3.2.34. An example of how contractual terms may affect transfer pricing may be seen in the following example:

Consider Company A in one country, an agricultural exporter, which regularly buys transportation services from Company B (its foreign subsidiary) to ship its product, cocoa beans, from Company A's Country to overseas markets. Company B occasionally provides transportation services to Company C, an unrelated domestic corporation in the same country as Company B. However, the provision of such services to Company C accounts for only 10 per cent of the gross revenues of Company B and the remaining 90 per cent of Company B's revenues are attributable to the provision of transportation services for cocoa beans to Company A. In determining the degree of comparability between Company B's uncontrolled transaction with Company C and its controlled transaction with Company A, the difference in volumes involved in the two transactions, volume 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.

Economic circumstances of the transaction

5.3.2.35. Economic analysis deals with industry analysis and the circumstances that may be relevant for determining market comparability.

The relevant information on the industry can be broadly classified 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 significant profits in emerging economies. Where there are such significant differences between the economic circumstances prevailing in different markets such that it is not possible to eliminate them by making reliable comparability adjustments, then companies from such different markets might not be retained as reliable comparables.

5.3.2.36. 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 positions of the buyers and sellers;
- Availability of substitutes;
- Government regulations of the market;
- Levels of supply and demand;
- Consumer purchasing power;
- Location-specific costs of production including the costs of land, labour, capital, transportation costs etc;

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

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

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

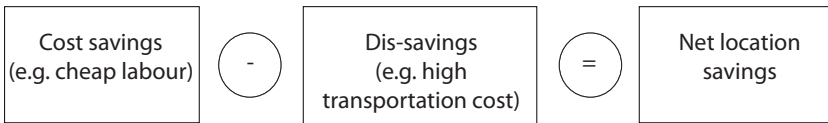
5.3.2.39. An example of a potential issue relating to geographic location is that of “location savings”, which may come into play during a transfer pricing analysis. Location savings are the net cost savings that an MNE realizes as a result of relocation of operations from a high-cost jurisdiction to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

- Labour costs;
- Raw material costs;
- Transportation costs;
- Rent;
- Training costs;

- Subsidies;
- Incentives including tax exemptions; and
- Infrastructure costs.

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.

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

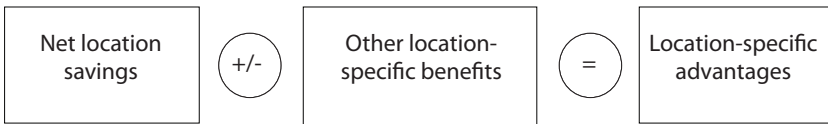


5.3.2.41 Location-specific advantages and location savings are defined as a type of benefit related to geographical location. The relocation of a business may in addition to location savings give some other location-specific advantages (LSAs). These LSAs could be, depending on the circumstances of the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

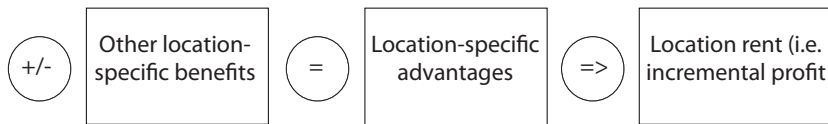
- Highly specialized skilled manpower and knowledge;
- Proximity to growing local/regional market;
- Large customer base with increased spending capacity;
- Advanced infrastructure (e.g. information/communication networks, distribution system); or
- Market premium.

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:



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



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

access to the LSAs, then the MNE may derive significant location rents associated with the LSAs, as the LSAs reflect a competitive advantage. These location rents may dissipate over time due to competitive pressure, depending on the facts and circumstances of each case.

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

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

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

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

5.3.2.48. The market level of the company is another key factor; for example, the price at the wholesale and retail levels would generally differ.

5.3.2.49. 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

5.3.2.50. On a general level business strategies are one of the important factors in a comparability analysis. However, the examination of the legitimate business strategy of an MNE will depend on the facts and circumstances of each case. The business strategy of an MNE is dependent upon the structural characteristics of 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, different corporate histories, internal efficiencies and competitive

advantages. Business strategies would take into account many aspects of an enterprise such as innovation and new product development; degree of diversification, risk aversion, assessment of political changes; impact of existing and planned labour laws, duration of arrangements and other factors bearing upon the daily conduct of business. Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions of the enterprises. However, the ultimate objective of a business strategy of an MNE is to improve its market share and/or overall profitability.

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

5.3.2.52. 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.

5.3.2.53. 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 competitive in the market; and
- Increasing their marketing and selling expenses through increased advertisement; sales promotion activities like offering rebates, free samples, offering extended warranties etc and increased marketing activities such as increasing its 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 referred tactics as precisely as possible so that the allocation of costs at arm's length can be computed.

5.3.2.54. Market penetration, market expansion and market maintenance strategies are legitimate business strategies that may involve substantial costs, sometimes resulting in significant losses. Accordingly, there is strong implicit recognition that market share strategies cannot be pursued indefinitely by a taxpayer and there has to be some definite time frame in the foreseeable future when these strategies might yield profits. 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 important 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;
- Whether unusually intense advertising, marketing and sales promotion efforts are taking place since these would provide a signal of market penetration or market share expansion strategies;
- The nature of the relationship between related parties, i.e. their responsibilities and risk profile;
- Whether the strategy involves 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 generally not bear the costs of a market penetration strategy initiated by its parent company.

5.3.2.55. When an MNE enters a new market with its product or expands market share of its product in an existing market through its subsidiary, questions of the creation of marketing intangibles and increases in the value of product-related intangibles such as trademarks, trade names etc follow closely behind. Therefore, it is important to examine and follow the process of creation of intangibles in a market, as well as the legal ownership of such intangibles and the right to share in the return from such intangibles (the notion which some countries refer to as “economic ownership”). 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.

5.3.3. Selection of the Tested Party

5.3.3.1. When applying the Cost Plus Method, Resale Price Method or Transactional Net Margin Method (see further Chapter 6) 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 comparables 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 transfer pricing method.

5.3.4. Identification of Potentially Comparable Transactions or Companies

5.3.4.1. Comparable uncontrolled transactions (“comparables”) are of two types:

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

Internal comparables

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

5.3.4.3 The advantages of internal comparables are:

- Internal comparables may have a more direct and closer relationship to the transaction under review than external ones due to one party to the transaction being the same 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.

5.3.4.4. 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.

5.3.4.5. 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.

5.3.4.6. 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 potential comparable transactions among third parties.

Third-party comparable/external comparable

5.3.4.7. 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 uncontrolled parties.

5.3.4.8. The second type of third party or uncontrolled comparable relates to comparable uncontrolled companies, for example in the application of profit-based methods. The identification and selection of these reliable external comparables can be executed in a five step process:

1. Examination of the five comparability factors for the controlled transaction;
2. Development of comparable search or “screening” criteria;
3. Approach to identifying potential comparables;
3. Initial identification and screening of comparables; and
4. Secondary screening, verification and selection of comparable.

5.3.4.9. 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

5.3.4.10. 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

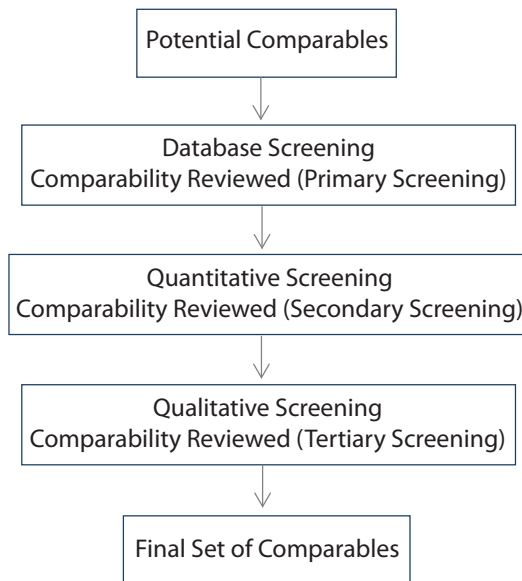
5.3.4.11. Comparable search or “screening” criteria are developed based upon the results of the above-mentioned examination of the five comparability factors in relation to the controlled transaction. These criteria must be defined so as to identify those external uncontrolled transactions that satisfy comparability *vis-à-vis* the controlled transaction and the tested party. The search criteria should be set so as to select the most reliable comparables. At the same time, the initial search criteria should not be overly restrictive, in order not to set unrealistic expectations in terms of comparability. Once potential comparables have been selected comparability adjustments can be performed where necessary to enhance the reliability of the comparisons. Availability of reliable comparables will influence the choice of the most appropriate transfer pricing method.

5.3.4.12. A typical process of comparable searching may be divided into three screening phases, namely (i) database screening (primary screening), (ii) quantitative screening (secondary screening) and (iii) qualitative screening (tertiary screening).

Potential comparables are reviewed in each of these phases to determine whether they qualify as comparables. 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 financial 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 diagnos-

tic ratio to reject or accept comparables based on the qualitative 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 specific transfer pricing method chosen:

Figure 5.1: Typical Screening Process



5.3.4.13. With regard to geographic location and 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 countries without access to relevant databases and with limited resources to analyze and adjust the foreign comparables.

5.3.4.14. 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 operating at the same level of market.

5.3.4.15. In considering the appropriate business mix, companies 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.

5.3.4.16. Comparables must be selected so that their financial 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.

5.3.4.17. Only uncontrolled transactions can be used as comparables. However, companies having small associated party transactions which do not materially affect their gross or net margin may still be used as uncontrolled comparables.

5.3.4.18. 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 financial 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.

5.3.4.19. External comparables must be selected such that the relevant 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.

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

5.3.4.21. 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 reliability of the set of comparables.

5.3.4.22. The application of diagnostic ratios is based on the assumption that a diagnostic ratio reflects a value driver of a particular line of business and is a reflection of the comparable functional and risk profile. 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 economically relevant for the comparable search process to be taken into account when performing the comparable search.

5.3.4.23. In order to identify potential comparables with a similar functional and risk profile a diagnostic ratio measuring for example the level of wage costs compared to an appropriate base (e.g. total operating costs or total turnover) can be used as a yardstick to measure the level of technical manpower employed by comparable companies engaged in software development. The identification of a diagnostic ratio will depend upon several factors 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.

5.3.4.24. 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

5.3.4.25. In identifying potentially comparable uncontrolled transactions or enterprises two approaches are possible: the “additive” and the “deductive”.

5.3.4.26. 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 transactions 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.

5.3.4.27. 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.

5.3.4.28. 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.

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

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

Deductive approach: initial identification and screening of comparables

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

5.3.4.32. 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.

5.3.4.33. The following analytical needs and constraints should however be kept in mind:

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

Secondary screening, verification and selection

5.3.4.34. Under this step, the search process focuses on a rigorous review of each transaction or company in the potential independent comparable pool against the full range of specific screening criteria. The objectives at this stage are verification, final screening and selection. This process is based on trial and error and requires multiple data sources, cross-checks and selected follow-up and confirmation of factual data.

5.3.4.35. The person performing the search for comparables may have to use a variety of information sources for third party or external comparables. These can include company-specific information sources including annual reports, regulatory and other government filings, product literature and securities analyst reports, as well as various trade and industry association materials. Once intermediate screening has been completed a complete set of company financial statement data should be generated and reviewed for adequacy, period coverage and general consistency. Sometimes details may even be obtained through telephone or personal interviews with company management and can also 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.

5.3.4.36. 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 databases to regulatory and other government filings and various analytical reports issued by trade and industry associations. The search objective is to identify the most reliable comparables for the controlled transaction under examination according to the specific set of criteria.

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

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

5.3.4.39. 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.

5.3.4.40. 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.

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

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

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 development 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 trademark 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 collecting 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.

Description of risks	X Co	Y Co (AE)	Comments
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 comparable 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 companies passing the criterion	Explanation
Company's main economic activity	764	Company primarily engaged in providing computer software, and 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 per cent
Qualitative analysis	8	Companies which fall under the category of "different line of business activity", "related party transactions", "loss making" (an average loss over a 3 year period) ^b and "data unavailable for review" were not considered.

^aThis 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.

^bThis is for the purpose of this example and does not mean that loss-making comparables should always be excluded. See Paragraphs 5.4.4.2. and 5.4.5. for discussion of losses.

5.3.4.43. 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:
 - Chambers of commerce;
 - Trade and professional organizations;
 - Embassies, consulates or trade missions; or
 - International organizations (e.g. the United Nations, the Organisation for Economic Cooperation and Development, the World Bank, the International Monetary Fund).

5.3.4.44. The following example addresses the practical application of screening.

5.3.5. Adjustments to Comparables

5.3.5.1. 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 short comings, adjustments may not be applied to poor comparables 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 intangibles 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 comparability analysis and should be appropriately documented in order to ensure its reliability.

5.3.5.2. Comparability adjustments can be divided into the following three broad categories:

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

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

5.3.5.4. 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 comparables, for example different depreciation periods, treatment of employee's stock options etc.

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

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

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

of the comparability characteristics of the potential comparable and merely making a working capital adjustment would not alleviate the problem.

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

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

5.3.5.9. The following example shows how the comparables results are adjusted to reflect the tested party's levels of working capital. The other approach could be that calculations are made to adjust the tested party's results to reflect the comparable's levels of working capital or to adjust both the tested party's results and the comparable's results to reflect "zero" working capital. In general, working capital adjustments are calculated for inventory, trade receivables and trade payables.

The method for calculating working capital adjustments for all three accounts follows the same basic approach. To begin with, a value is calculated for differences in levels of working capital between the tested party and the comparable party relative to the appropriate base. The appropriate base will be the denominator used for calculating the PLI which can either be costs, sales or assets. The resulting difference in the ratios is then multiplied by an appropriate interest rate. A working capital (WC) adjustment so computed is either adjusted to the comparable's PLI or to the Tested Party's PLI for the purpose of comparison.

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

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

Box Table 5: Working capital adjustment

Particulars	Tested Party	Comparable Party
Sales (A)	100	120
Earnings before interest and taxes (EBIT) (B)	5	7
Operating profit margin (PLI) (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 comparable 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%

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

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

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

5.3.5.13. Adjustments performed to adjust for material differences in the mix of functions performed by a controlled storage device distributor and a set of independent storage device distribution comparable is considered here to illustrate this point. It is assumed that the independent device distributors (determined to be the best available comparables) also perform manufacturing/assembly operations and

downstream distribution functions that are not performed by the controlled storage device distributor. In this case, the financial results of the comparables may need to be adjusted to eliminate the profits associated with manufacturing/assembly operations and with downstream distribution functions based upon the profitability earned in uncontrolled comparable storage manufacturing and downstream distribution transactions. In other words, for comparability purposes, only the functions comparable to the functions carried out by the controlled storage device distributor should be taken into consideration.

5.3.5.14. To contrast the treatment above with a different set of circumstances, it is assumed that the controlled storage device distributor above performs some import functions which are not performed by the independent distributors. The margins of those comparables that did not perform import functions would, in these circumstances, need to be adjusted to reflect an arm's length profit associated with these functions.

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

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

5.3.5.17. The degree of comparability between a tested party and an uncontrolled taxpayer is impaired when the entities assume different economically significant risks which may require making a risk adjustment. For example, a contract manufacturer in certain circumstances does not usually assume the market risk that full-fledged manufacturers customarily do.

5.3.5.18. There is no universally accepted method for risk adjustment. However, in practice MNEs carry out risk adjustment through

application of certain methods that attempt to quantify on an *ex ante* basis (i.e. before the event) the effect of risk on anticipated profitability based on, for example, the weighted average cost of capital/capital asset pricing model. However it is worth mentioning that both models are based upon risk models used mainly in relation to the risk of securities. Most statistical methods have their inherent limitations. Therefore, risk adjustment must be made carefully and only where needed and if a reasonable and accurate adjustment is possible.

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

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

5.3.5.21. In some cases material differences may exist in the way transactions are structured by potential comparables and by the tested party, due to the fact that the latter operates with associated enterprises in an MNE 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 example the margins of independent distributors operating on short-term contracts may not be comparable to those of associated enterprises on long-term contracts, unless an adjustment is made to account for the short duration of the former.

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

considered, the quality of the data used in the adjustment, the purpose of the adjustment and the reliability of the approach used to make the adjustment.

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

5.3.5.24. No specific rules or guidelines can be given that may be applicable to every transaction or indicate that comparability adjustments must be made. In each case, the critical factors that have a material 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.

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

5.3.6. Comparability Considerations in the Selection of Transfer Pricing Methods

5.3.6.1. The degree of comparability between the controlled and the uncontrolled transactions, including the reliability of comparability adjustments needed and the availability of reliable information (especially on uncontrolled comparables) are key factors in selection of the most appropriate transfer pricing method. Other factors include the strengths and weaknesses of the method, the appropriateness of the method in the light of the nature of the controlled transaction (based upon a functional analysis), etc. For further information see Chapter 6.

5.3.6.2. Once the taxpayer has identified the transfer pricing methods that are potentially applicable to the controlled transaction, application 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 uncontrolled 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 information 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.

5.3.7. Determination of an Arm's Length Price or Profit (or Range of Prices or Profits)

5.3.7.1. Once the transfer pricing method is selected, the next logical 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 Chapter 6 on Methods.

5.3.8. Documentation of the Comparability Analysis and Monitoring

5.3.8.1. Another important and necessary requirement while performing the comparability analysis is to maintain complete documentation of the analysis, evaluation and selection (as well as rejection) 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. Chapter 7 deals in detail with documentation requirements.

5.4. Issues Regarding Comparability Analysis

5.4.1. General

5.4.1.1. The comparability analysis should be as reliable as possible 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.

5.4.2. Timing Issues

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

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

5.4.2.3. 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 circumstances would not base their pricing decision on historical data alone. This ex ante analysis of the arm's length price is however not the most common approach.

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

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

5.4.2.6. 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 valuation uncertainty in the pricing of the transaction.

5.4.2.7. The main issue is to:

- Determine whether the valuation was sufficiently uncertain at the outset that the parties at arm's length would have required a price adjustment mechanism; or
- Whether because the change in value was so fundamental, or other developments arose, this would have led to a re-negotiation of the transaction.

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

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

5.4.3. Lack of Reliable Comparables

5.4.3.1. One of the most frequent problems taxpayers and administrations face with comparability analysis is the lack of reliable comparables with respect to the transaction(s).

5.4.3.2. The lack of comparables for a taxpayer's controlled transaction 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 applicable 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 transaction are such that 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

5.4.3.3. In many developing countries, reliable comparable transactions 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 comparables, possibly adjusted, to deal with these situations, but even then the administration may not have access to relevant databases and is therefore very reliant on the taxpayer's use of the data.

5.4.3.4. 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 manufacturer 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.

5.4.3.5. 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

5.4.3.6. 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.

5.4.3.7. Owing to consolidation and vertical integration, it may be extremely difficult in some industries to find reliable internal or external comparables. An example is the pharmaceutical industry where there exists a high level of vertical integration and consolidation in

order to drive up efficiencies. In such scenarios the controlled transactions are part of a larger global supply-chain and it can be difficult to find comparable transactions between independent enterprises. In such cases also, it may be possible under certain circumstances to use comparables from other industries, possibly adjusted, in order to address this issue.

5.4.4. “Cherry-picking” of Comparables

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

5.4.4.2. For example, extreme results may be rejected as comparables after careful consideration the tax authorities as they tend to skew the data. While this could on the one hand be a correct application 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 comparables. This may be e.g. 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.

5.4.4.3. 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 transaction 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 generate 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.

5.4.4.4. Well-documented search procedures and comparability 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.

5.4.5. Losses

5.4.5.1. 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 recurring one, but the overall group may be extremely profitable. An enterprise that is doing business with profitable members of its MNE group while generating losses itself may warrant scrutiny by the tax authorities 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.

5.4.5.2. 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.

5.4.5.3. 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.

5.4.5.4. 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 situations 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.

5.4.5.5. Start-up-losses: Depending on the place of business and the line of trade or industry, a new business entity may be unprofitable 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 questionable in the initial years as it may be reasonable.

5.4.5.6. Deliberate business strategies: An MNE might undertake deliberate business strategies for market penetration to increase market share and the profit potential, resulting in losses in some jurisdictions. 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 circumstances 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 penetration strategy.

Losses caused by recession

5.4.5.7. 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.

5.4.5.8. 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 important 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.

5.4.5.9. The sharing or absorption of the losses due to a recession 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.

5.4.5.10. 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 distributor would not share in such loss at arm's length.

5.4.5.11. Losses may arise from increased competition, Sometimes a product faces competition because 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 analysis should determine which legal entity should bear the cost of "market competition". Depending upon the comparability analysis, including the functional analysis, a possible solution may be that this cost is borne by a full-fledged manufacturer with considerable entrepreneurial risk.

5.4.5.12. Losses may occur due to product life-cycle issues; the life cycle has four phrases: 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 products 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.

5.4.5.13. Losses arising from quality issues is 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 manufacturing activities. The party responsible for the design or R&D, depending upon the facts and circumstances including the risk profile of the entities in question, may need to bear the losses arising from that faulty design or R&D.

5.4.6. Intentional Set-offs

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

5.4.6.2. 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.

5.4.6.3. The tax authorities may evaluate the transactions separately to determine whether the transactions satisfy the arm's length

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

5.4.7. Use of Customs Valuations

5.4.7.1. The price of goods (and under certain circumstances services—the so-called “additional”) 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 may prefer to determine a higher price on the same imports so as to collect more customs duty. These inherent differences in focus accentuate the challenge tax administrations face in harmonizing existing transfer pricing and customs valuation methods and principles.

5.4.7.2. The General Agreement on Tariffs and Trade (GATT, Article VII), now part of the World Trade Organizations (WTO) set of agreements, has laid down the general principles for an international system of customs valuation. Customs valuation is the procedure applied to determine the customs value of imported goods. Member countries of the WTO typically harmonize their internal legislation dealing with customs valuation according to the WTO Agreement on Customs Valuation.⁵¹ The tax authorities in most of the member countries use the “arm’s length principle” as a standard as set out in OECD Transfer Pricing Guidelines. It is important to note here that both the guidelines set by the WTO and OECD aim at determining a “fair price”; the approaches of the customs authorities and direct tax authorities are however often different and incompatible due to different motivations and aims. 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.

⁵¹See http://www.wto.org/english/tratop_e/cusval_e/cusval_e.htm

5.4.7.3. In appropriate circumstances the documented customs valuation 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. The arm's length principle is applied, broadly speaking, by many customs administrations as a principle to ensure that the price of an associated party transaction has not been affected by the special relationship between the parties. Customs authorities in some instances use comparisons between the value attributable to goods imported by associated enterprises and the value for identical or similar goods imported by independent enterprises. There are some similarities between customs valuation and transfer pricing methods, although the former may not be aligned with the latter. Examining customs valuations may provide relevant information and a useful starting point for transfer pricing purposes and may also help in reducing the compliance burden for taxpayers.

5.4.7.4. However, when there is no customs duty imposed and goods are valued only for statistical purposes, and for transactions or items which have no rate of duty (e.g. services or transfers of intangibles), relying on customs valuation would not be useful. Furthermore, customs valuation and transfer pricing relate to different areas of taxation: They operate differently and are used for different objectives.

5.4.7.5. Even when utilizing customs valuation for imports in a transfer pricing context, certain additional upward or downward adjustments may be required to derive the arm's length price for the purpose of direct taxation.

5.4.7.6. There is a great deal of focus internationally on the interplay between transfer pricing and customs valuation methods. Debates have centred on the feasibility and desirability of the convergence of the valuation and/or administrative systems surrounding the two sets of value determination. Those who favour convergence point to the higher compliance costs to business and higher enforcement costs to government arising out of two sets of rules existing in the same government. The opponents of this idea point to the different principles underlying the determination of value, for the levy of customs duty and the levy of tax on profits.

5.4.8. Use of Secret Comparables

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

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

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

5.4.9. Recognition of the Transaction Actually Undertaken

5.4.9.1. In most cases (other than exceptional situations) the arm's length price must be established with regard to the controlled transaction actually undertaken by the associated enterprises as it has been structured by them. Further, such prices should be established using

the methods applied by the taxpayer, provided that these are consistent with the arm's length principle. Tax authorities should not substitute other transactions in the place of those that have actually happened and should not disregard those transactions actually undertaken, unless there are special circumstances. Exceptional circumstances may be present where the economic substance of the transaction differs from its form; also there may be transactions, where the form and substance are the same, but the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price. In such cases, the actual structure practically impedes the tax administration from determining an appropriate transfer price.

5.4.9.2. In general, restructuring of transactions should not be lightly undertaken as it would create significant uncertainty for taxpayers and may lead to double taxation due to the divergent views of the countries on how the transactions are structured. Whether tax authorities are able to do so depends on their powers under applicable domestic law. See further Chapter 3.

5.4.10. Overall Process Complexity

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

5.4.10.2. 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.

5.4.10.3. 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.

5.5. Conclusion

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

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

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

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

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

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

Chapter 6

TRANSFER PRICING METHODS

6.1. Introduction to Transfer Pricing Methods

6.1.1. This part of the chapter describes several transfer pricing methods that can be used to determine an arm's length price and describes how to apply these methods in practice. Transfer pricing methods (or "methodologies") are used to calculate or test the arm's length nature of prices or profits. Transfer pricing methods are ways of establishing arm's length prices or profits 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 methods helps assure that transactions conform to the arm's length standard. It is important to note that although the term "profit margin" is used, companies may also have legitimate reasons to report losses at arm's length. Furthermore, transfer pricing methods are not determinative in and of themselves. If an associated enterprise reports an arm's length amount of income, without the explicit use of one of the recognized transfer pricing methods, this does not mean that its pricing should automatically be regarded as not being at arm's length and there may be no reason to impose adjustments.

6.1.2. Selection of Methods (How, Why and Use of Methods)

6.1.2.1. 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 transaction; the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method; and the degree of comparability between the controlled and uncontrolled transactions.

The starting point in selecting a method is an understanding of the controlled transaction (inbound or outbound), in particular 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 appropriate because the transaction, function, allocation of risks or allocation of assets have been modified.

The major components of a functional analysis are analyses of the functions, assets and risks. The functional analysis is described and discussed in detail in Chapter 5, at Paragraph 5.3.2.2. Appendix I provides examples of a functional analysis for a manufacturing business and a distribution business. A summary is provided here for context in the case of selection of appropriate methods.

6.1.2.2. The functions performed: The functional analysis describes the activities performed such as design, purchasing, inbound logistics, manufacturing, research and development (R&D), assembling, inventory management, outbound logistics, marketing and sales activities, after sale services, supporting activities, services, advertising, financing and management, etc. The functional analysis must specify which party performs each activity and 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.

6.1.2.3. The risks undertaken: The functional analysis should identify risks undertaken. Examples are: financial risk (currency, interest rate, funding risks etc) credit and collection risk (trading credit risk, commercial credit risk), operational risk (systems failure risk), commodity price risk, inventory risk and carrying costs, R&D risk, environmental and other regulatory risks, market risk (country political

risk, reliability of customers, fluctuation in demand and prices) and product risk (product liability risk, warranty risk and costs 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.

6.1.2.4. The assets used or contributed: The functional analysis 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 substantial 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, marketing intangibles, etc).⁵²

6.1.2.5. 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 analyses both more difficult and more necessary. The functional analysis can help identify which functions, risks and assets are attributable to the various related parties. For example, the functional analysis may reveal that one company performs one particular function but the cost of this is borne by the other party to the transaction. The functional analysis could highlight that situation and consider the legal allocation of risk and the economic substance of the transaction. Another example would be where a company performs one particular function and bears the cost thereof but the benefit also accrues to the other party to the transaction. The functional analysis could emphasize that situation and consider which party bears the risk in legal terms and which party bears the risk according to the economic substance of the transaction. The functional analysis typically includes a discussion of the industry in which the tested party operates, the contractual terms of the

⁵²See glossary for a definition of marketing intangibles; the term is used extensively in the OECD Transfer Pricing Guidelines at Paragraphs 2.138, 2.32, 6.1, 6.3–6.6, 6.8, 6.12, 6.24, 6.36–6.39, 9.77, 9.90 and 9.127.

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.

6.1.2.6. Selecting a method after the functional analysis: Once the functional analysis is performed the application of a transfer pricing method, with the associated evaluation of comparable transactions, may be considered. Transfer pricing methods typically use information on comparables; the lack of such comparables can make a particular method — even one that might seem initially preferred — inapplicable, and a different method more reliable. These comparable transactions are also referred to as “uncontrolled transactions” because the parties involved in the transactions are independent of each other. Although uncontrolled transactions of independent unrelated companies are usually used as comparables for transfer pricing purposes, in practice it is sometimes not possible to identify reliable 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 5.

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

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

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

6.1.2.8. 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 ownership 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.⁵³

6.1.3. Choice of Available Methods

6.1.3.1. 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 methods” 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.

6.1.3.2. 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 transactions and the possibility of making adjustments to the data to improve comparability. For further discussion on this issue, see Chapter 5.

6.1.3.3. Once a method is chosen and applied, taxpayers are generally expected to apply the method in a consistent fashion. Assuming

⁵³The Subcommittee discussed the possibility of preparing more detailed guidance on intangibles in a separate Chapter of this Manual, but was unable to complete the work in the time available. This item will be added to the programme of work with a view for completion for the next edition of the Manual.

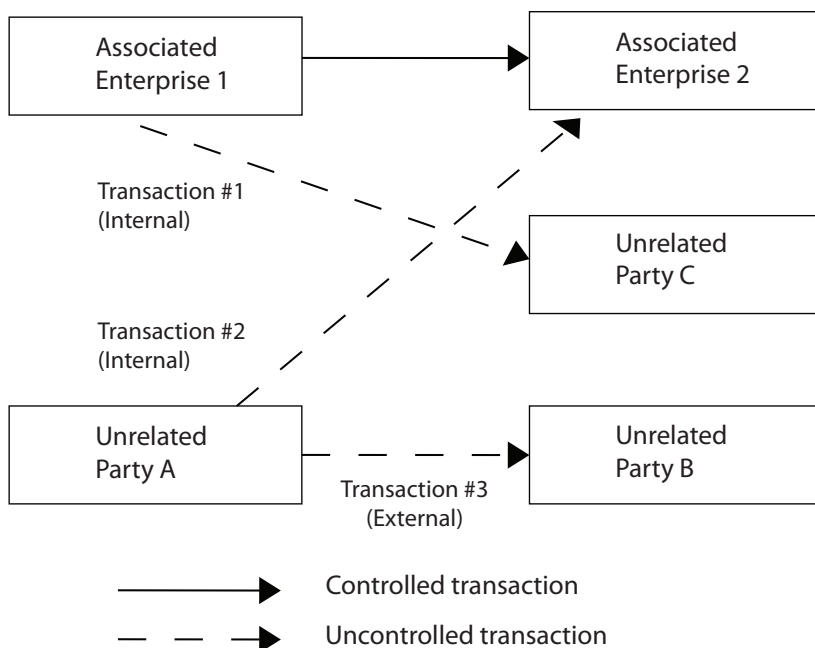
that an appropriate transfer pricing method is being applied, a change in the method is typically required only if there are any changes in the facts, functionalities or availability of data.

6.2. Traditional Transaction Methods

6.2.1. Comparable Uncontrolled Price

6.2.1.1. The Comparable Uncontrolled Price (CUP) Method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. The CUP Method may also sometimes be used to determine the arm’s length royalty for the use of an intangible asset. CUPs may be based on either “internal” comparable transactions or on “external” comparable transactions. Figure 6.1 below explains this distinction in the context of a particular case study.

Figure 6.1: Comparable Uncontrolled Price Method



6.2.1.2. 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.

6.2.1.3. 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 uncontrolled transaction between Unrelated Party A and Unrelated Party B (i.e. transaction #3).

6.2.1.4. Comparable uncontrolled transactions, such as transaction #1 or #2, which involve a transaction between the tested party and an uncontrolled party, are referred to as internal comparables. Comparable uncontrolled transactions such as transaction #3, which involves a transaction between two parties neither of which is an associated enterprise, are called external comparables. The application of the CUP Method involves a detailed transactional comparison whereby the controlled and uncontrolled transactions are compared based on the five comparability factors mentioned in Chapter 5.

6.2.2. Comparability in Application of the CUP Method

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

- There are no differences in the transactions being compared that would materially affect the price; or

- Reasonably accurate adjustments can be performed to account for material differences between the controlled and the uncontrolled transaction.

6.2.2.2. In performing the comparability analysis, the controlled transactions and uncontrolled transactions should be compared based on the comparability factors mentioned earlier and stated in detail in Chapter 5. In determining the degree of comparability between the controlled transactions and uncontrolled transaction #1 in Figure 6.1, for example, the following factors should be taken into account: (i) characteristics of property being transferred or services provided, (ii) contractual terms, (iii) economic circumstances and (iv) business strategies. For the functional analysis it is necessary to analyse the functions performed, the risks assumed and the assets used.

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

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

6.2.2.5. 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 6.1 sells similar bicycles to Associated Enterprise 2 and Unrelated Party C. All relevant information on the controlled and uncontrolled transactions is available to

Associated Enterprise 1, and hence it is probable that all material differences between the transactions can be recognized.⁵⁴ The uncontrolled price can be adjusted for the difference in delivery terms to eliminate the effect of this difference on the price;

- Volume of sales and related discounts. E.g. Associated Enterprise 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 analysed, 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 6.1 involve bicycles on which modifications have been made. However, the bicycles sold in the controlled transactions do not include these modifications. If the product modifications have a material effect on price, then the uncontrolled price should be adjusted to take into account this difference in price);
- Contractual terms. E.g. Associated Enterprise 1 sells the bicycles to Associated Enterprise 2 offering a 90 day credit term but the contract terms dictate that all sales to Unrelated Party C are Cash On Delivery;
- 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

⁵⁴It is assumed that the circumstances relating to the controlled and uncontrolled transactions are similar. The only material difference that could be identified between the transactions is that the price relating to the controlled transaction is a delivered price (i.e. including transportation and insurance), while the uncontrolled transaction #3 is made ex works, with the buyer taking responsibility from the named place of delivery, which is Associated Enterprise 1's factory (the "works"). It is possible to perform reasonably accurate adjustments for this difference.

risk of its customers' default. This difference in risk allocation must be analysed and its effect on price quantified before Associated Party 2's prices and Unrelated Party C's prices can be considered comparable; and

- Geographical factors. E.g. Associated Enterprise 1 sells bicycles to Associated Enterprise 2 located in South Africa, while Unrelated Party C, to which it also sells the same bicycles, is located in Egypt. The only material difference that could be identified between the controlled and uncontrolled transactions concerns the locale. To perform adjustments to account for this difference one might have to consider, for example, differences in inflation rates between South Africa and Egypt, the competitiveness of the bicycle market in the two countries and differences in government regulations if relevant.

6.2.2.6. Reasonably accurate adjustments may *not* be possible for:

- Unique and valuable trademarks. E.g. assuming Associated Enterprise 1 in Figure 6.1 is engaged in manufacturing high value branded goods, and attaches its valuable trademark to the goods transferred in the controlled transaction, while uncontrolled transaction #1 concerns the transfer of goods that are not branded. The effect of the trademark on the price of a watch may be material. However it will be difficult, if not impossible, to adjust for effect of the trademark on price since the trademark is an intangible asset that is unique. If reasonably accurate adjustments cannot be made to account for a material product difference the CUP Method may not be the appropriate method for the transaction; and
- Fundamental differences in the products E.g. if the products being sold are significantly different from the products sold in the proposed comparable transaction it may not be possible to adjust for the product differences.

6.2.2.7. Notwithstanding the difficulties often associated with adjustments to address the sources of non-comparability described above, the need to make adjustments should not automatically prevent

the use of the CUP Method. It is often possible to perform reasonably accurate adjustments. 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.

6.2.3. Strengths and Weaknesses of the CUP Method

6.2.3.1. The strengths of the CUP Method include that it:

- Is a two-sided analysis as the price used reflects the agreed price between two unrelated parties to the transaction;
- Avoids the issue of which of the related parties involved in the controlled transaction should be treated as the tested party for transfer pricing purposes;⁵⁵
- Involves a direct transactional comparison of a similar transaction between unrelated parties. That is, it is a more direct measure of the arm's length price than the other methods, all of which 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.

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

⁵⁵This 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 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.

6.2.4. When to Use the CUP Method

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

6.2.4.2. In the example represented in Figure 6.1 above, this would involve two distinct questions: (i) whether Associated Enterprise 1 sells comparable bicycles to an unrelated party and (ii) whether Associated Enterprise 2 purchases comparable bicycles from one or more unrelated bicycle manufacturers. If the answer to either one of these questions is in the affirmative then the next step in the analysis is to determine the degree of comparability between the controlled and uncontrolled transactions based on the comparability factors.

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

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

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

6.2.5 Case Examples of Use of the CUP Method

6.2.5.1 Example 1: Comparable Sales of Same Product

MCO, a manufacturer, sells the same product to both controlled and uncontrolled distributors. The circumstances surrounding the controlled and uncontrolled transactions are substantially the same, except that the controlled sales price is a delivered price and the uncontrolled sales are made free on board (f.o.b.) MCO's factory (which means the buyer takes responsibility for delivery costs of the goods for the remainder of their transit). Differences in the contractual terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, and adjustments are made to the results of the uncontrolled transaction to account for such differences. No other material difference has been identified between the controlled and uncontrolled transactions. As MCO is engaged in both controlled and uncontrolled transactions, it is likely that all material differences between the two transactions have been identified. In 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.

6.2.5.2 Example 2: Effect of Trademark

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

6.2.5.3 Example 3: Minor Product Differences

The facts are the same as in Example 1 except that MCO, which manufactures business machines, makes minor modifications to the physical properties of the machines to satisfy specific requirements of a customer

in controlled sales. MCO does not however make these modifications in uncontrolled sales. Only if the minor physical differences in the product have a material 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.

6.2.5.4. Example 4: Effect of Geographic Differences

FM, a specialty radio manufacturer, sells its radios to a controlled distributor, AM, within the western region of Country A. FM sells its radios to uncontrolled distributors to serve other regions in Country A. The product sold in the controlled and uncontrolled transactions is the same and all other circumstances surrounding the controlled and uncontrolled transactions are substantially the same other than the geographic differences. If the geographic differences are unlikely to have a material effect on price, or they have definite and reasonably ascertainable effects for which adjustments are made, then the adjusted results of the uncontrolled sales may be used under the 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.

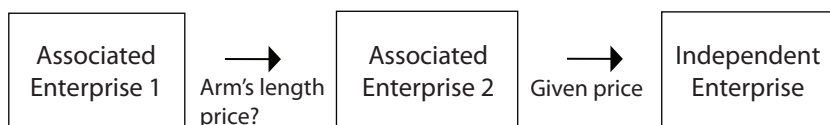
6.2.6. Resale Price Method

6.2.6.1. The Resale Price Method (RPM) is one of the traditional transaction methods that can be used to determine whether a transaction 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 6.2 below.

6.2.6.2. The Resale Price Method analyses the price of a product that a related sales company (i.e. Associated Enterprise 2 in Figure 6.2) charges to an unrelated customer (i.e. the resale price) to determine an arm's length gross margin, which the sales company retains to cover its sales, general and administrative (SG&A) expenses, and still make an appropriate profit. The appropriate profit level is based on the functions it performs and the risks it incurs. The remainder of the product'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 6.2: Resale Price Method



Given price	=	US\$100
<u>Resale price margin (25%)</u>	=	US\$ 25
Arm's length price	=	US\$ 75

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

$TP = RSP \times (1 - GPM)$, where:

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

6.2.6.4. Example of Resale Price Method Application

It is assumed that the resale price in Figure 6.2 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 per cent, Associated Enterprise 2 should cover its SG&A expenses and make an appropriate profit with this 25 per cent gross margin. The resulting transfer price between Associated Enterprise 1 and Associated Enterprise 2 (i.e. the cost of goods sold of Associated Enterprise 2) is \$75 (i.e. $\$100 \times (1-0.25)$).

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

6.2.7. Arm's Length Gross Profit Margin

6.2.7.1. The financial ratio analysed 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 transfer price paid to the related manufacturer.

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

6.2.8. Transactional Comparison versus Functional Comparison

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

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

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

6.2.8.3. 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.

6.2.9 Comparability in Applying the Resale Price Method

6.2.9.1. An uncontrolled transaction is considered comparable to a controlled transaction if:

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

6.2.9.2. As noted above, the Resale Price Method is more typically applied on a functional than on a transactional basis so that functional comparability is typically more important than product comparability. Product differences will probably be less critical for the 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 different activities.

6.2.9.3. 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.

6.2.9.4. 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 distributors engaged in the sale of markedly different products cannot be compared. The price of a washing machine will, of course, differ from the price of a dryer, as the two products are not substitutes for each other. Although product comparability is less important under

the 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 distributed 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.

6.2.9.5. 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 comparability adjustments should be performed on the gross profit margins of the uncontrolled transactions. The operating expenses in connection 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.

6.2.9.6. The following issues should be considered in determining whether the functions performed by an uncontrolled entity are comparable 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 differences could affect gross margins even if they do not affect the arm's length prices of products (e.g. the composition of COGS). These factors could include cost structures (e.g. accounting practices), business experience (e.g. start-up phase or mature business) or management efficiency;
- A resale price margin requires particular attention where the reseller adds substantially to the value of the product, for example by assisting considerably in the creation or maintenance of 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 relation to the resale activity itself, or if it employs valuable and unique assets in its activities (e.g. valuable marketing intangibles of the reseller), it may earn a higher gross profit margin;
- The comparability analysis should try to take into account whether the reseller has the exclusive right to resell the goods, because exclusive rights may affect the resale price margin;
- The analysis should consider differences in accounting practices that apply to the reseller and to comparable companies in order to make appropriate adjustments to enhance comparability; and
- The reliability of the analysis will be affected by differences in the value of the products distributed, for example, as a result of a valuable trademark.

6.2.9.7. 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 operating in the same market.

6. 2.10. Strengths and Weaknesses of the Resale Price Method

6.2.10.1. 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 inelastic, the resale price may be more reliable; and

- The method can be used without forcing distributors to inappropriately “make profits”. The distributor earns an arm’s length gross profit margin, however, 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 analyses a financial ratio based on operating profits, will generally result in an arm’s length range of positive operating profits. The tested party in the analysis would then 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.

6.2.10.2. 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 supplier is profitable).

6.2.11. When to Use the Resale Price Method

6.2.11.1. 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 properties; and
- Reliable comparisons can be made on COGS.

6.2.11.2. It is useful to again consider the example of Figure 6.1. 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 generally 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 manufacturers comparable to Associated Enterprise 1 (i.e., that own comparable intangible properties) when applying the Cost Plus Method.

6.2.11.3. 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.

6.2.11.4. The Resale Price Method may also be applied in a commissionaire/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.

6.2.12. Case Examples of the Resale Price Method

6.2.12.1. 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 uncontrolled comparable is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and 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 per cent, then an arm's length result of the controlled sale is a price of \$80 ($\$100 - (0.2 \times \$100)$).

6.2.12.2. 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, consisting of \$600 for property purchased from FP and \$200 for other costs of goods sold incurred to unrelated parties. SCO's applicable resale price and reported gross profit are as follows:

Applicable resale price	\$1 000
Cost of goods sold:	
Cost of purchases from FP	\$600
Costs incurred to unrelated parties	\$200
Reported gross profit	\$200

The local taxing authority determines that the appropriate gross profit margin is 25 per cent. Therefore, SCO's appropriate gross profit is \$250 (i.e. 25 per cent of the applicable resale price of \$1000). As SCO is incurring costs of sales to unrelated parties, an arm's length price for property purchased from FP must be determined under a two-step process. First, the appropriate gross profit (\$250) is subtracted from the applicable resale price (\$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.

6.2.12.3. 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.

6.2.12.4. 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 per cent earned by TCO is an arm's length result, the local taxing authority considers applying the Resale Price Method. There are several uncontrolled distributors that perform similar functions under similar circumstances in uncontrolled transactions. However, the uncontrolled distributors treat certain costs such as discounts and insurance as cost of goods sold, while TCO treats such costs as operating expenses. In such cases, accounting reclassifications must be made to ensure consistent treatment of such material items. Inability to make such accounting reclassifications will decrease the reliability of the results of the uncontrolled transactions.

6.2.12.5. 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 uncontrolled parties in that country. Uncontrolled Distributors A, B, C, D, and E distribute competing products of approximately similar value in Country R. All such products are unbranded.

Relatively complete data 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 sufficiently 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 ascertainable effect; and reliable adjustments are made to account for such differences, the results of each of the uncontrolled distributors may be used to establish an arm's length range.

6.2.12.6. 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 provide warranties or to determine the payment terms of the contracts. As differences in these contractual terms could materially affect price or profits, the inability to determine whether these differences exist between the controlled and uncontrolled transactions diminishes the reliability of the results of the uncontrolled comparables. However, the reliability of the results may be enhanced by the application of a statistical method when establishing an arm's length range.

6.2.12.7. 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 application of the Resale Price Method as for the Comparable Uncontrolled Price Method, significant differences in the value of the products involved in the controlled and uncontrolled transactions may affect the reliability of the results. In addition, because in this case it is difficult to determine the effect the trademark will have on price or profits, reliable adjustments for the differences cannot be made. Because transactions involving Companies D and E have a higher level of comparability than

those involving Companies A, B, and C with Company S, only transactions involving Companies D and E may be included in determining the arm's length gross margin.

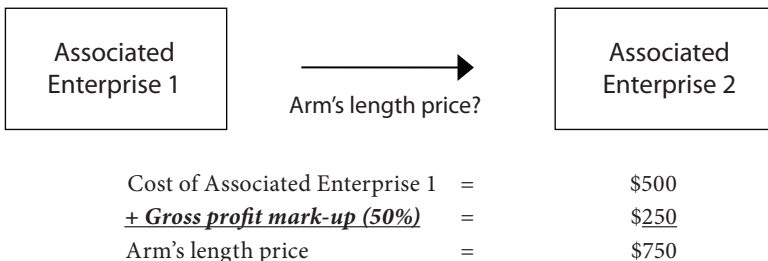
6.2.13. Cost Plus Method

6.2.13.1. 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.

6.2.13.2. 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.

6.2.13.3. The Cost Plus Method is used to analyse 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 manufacturer or service provider as the tested party in the transfer pricing analysis. 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 6.3: Cost Plus Method



It is assumed that the COGS in Figure 6.3 is \$500. If it is assumed also that an arm's length gross profit mark-up that Associated Enterprise 1 should earn is 50 per cent, the resulting transfer price between Associated Enterprise 1 and Associated Enterprise 2 is \$750 (i.e. $\$500 \times (1 + 0.50)$).

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.

6.2.13.4. Figure 6.3 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 CUP 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 analysis in this case. The Cost Plus Method analyses whether the gross profit mark-up earned by Associated Enterprise 1 is at arm's length by reference to the gross profit margins earned by companies manufacturing comparable goods for (or providing comparable services to) unrelated parties. The 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.

6.2.14. Mechanism of the Cost Plus Method

6.2.14.1. 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.

6.2.14.2. The formula for the transfer price in inter-company transactions of products is as follows: $TP = COGS \times (1 + \text{cost plus mark-up})$, where:

- TP = the *Transfer Price* of a product sold between a manufacturing company and a related company;
- COGS = the *Cost of Goods Sold* to the manufacturing company; and
- Cost plus mark-up = gross profit mark-up defined as the ratio of gross profit to cost of goods sold. Gross profit is defined as sales minus cost of goods sold.

6.2.15. Arm's Length Gross Profit Mark-up for Cost Plus Method

6.2.15.1. 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 manufacturing company, cost of goods sold equals the cost of producing the goods sold. It includes direct labour costs, direct material costs and factory overheads associated with production.

6.2.15.2. 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 comparable manufacturers may differ from the related party manufacturer in reporting certain costs (e.g. costs of R&D) as operating expenses or as cost of goods sold. Differences in inventory valuation methods will also affect the computation of the gross profit mark-up.

6.2.15.3. The costs and expenses of a company normally fall into the following three groups: (1) direct cost of producing a product or service (e.g. cost of raw materials); (2) indirect costs of production (e.g. costs of a repair department that services equipment used to manufacture different products); and (3) operating expenses (e.g. 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 indirect costs of production from the sales price. In contrast, a net margin analysis would also consider operating expenses. Due to differences in accounting standards between countries, the boundaries between

the three groups of costs and expenses are not the same in each and every case. Suitable adjustments may need to be made. In a situation in which it is necessary to consider certain operating expenses to obtain consistency and comparability, a net margin method will typically be more reliable than the Cost Plus Method, as discussed below.

6.2.15.4. 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 per cent on its cost of goods sold and classifies certain expenses (like warranty expenses) as operating expenses that are not part of cost of goods sold. Four comparable independent manufacturers are identified which earn gross profit mark-ups between 10 to 15 per cent. 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.

6.2.16. Transactional Comparison versus Functional Comparison

6.2.16.1. 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).

6.2.16.2. The arm's length (range of) gross profit mark-up(s) can be established in the following two ways:

- Transactional comparison: the gross profit mark-up earned by the related party manufacturer when selling goods to an independent enterprise in a comparable uncontrolled transaction, which previously has been rejected as an internal comparable for purposes of applying the CUP Method because for example, it involves different models of bicycle.

If for example the controlled transaction involves the manufacturing of recreational bicycles, but the unrelated transactions involve bicycle rickshaws etc, these may involve broadly similar products, with comparable accounting measures of COGs making gross margin comparisons sufficiently reliable; and

- Functional comparison: the gross profit mark-ups earned by independent companies performing functions and incurring risks comparable to the functions performed and risks incurred by the related party manufacturer. Functional comparison involves a search for comparable manufacturing companies.

6.2.16.3. 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 uncontrolled transactions is available (e.g. contractual terms). In a functional comparison that is based on information provided in publicly available databases and in the annual reports of comparable companies and the tested party, much less specific information is available with respect to the functions performed and risks incurred by the companies. Consequently, it would be more likely in these circumstances that a net margin method would be used, see below at Paragraph 6.3.2.

6.2.16.4. Based on benchmarking and financial analyses an arm's length range of gross profit mark-ups earned by comparable independent manufacturers will be determined. If the gross profit mark-up earned by the related party manufacturer falls within this range, then its transfer price will be considered arm's length.

6.2.17. Comparability

6.2.17.1. 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 compared that materially affect the gross profit mark-up; or
- Reasonably accurate adjustments can be performed to adjust for the effect of such differences.

6.2.17.2. As with the Resale Price Method, and for the same reasons, close similarity of products in the controlled and uncontrolled transactions is less important under the Cost Plus Method than under the CUP Method, while functional comparability (including comparability 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.

6.2.17.3. As the gross profit mark-up remunerates a manufacturing 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 transactions, adjustments should be made to account for such differences. In general, comparability adjustments should be made on the gross profit mark-ups of the uncontrolled transactions. Sometimes the operating expenses in connection with the functions performed and risks incurred will be taken into account as differences in functions performed may be reflected in the operating expenses.

6.2.18. Determination of Costs

6.2.18.1. 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 differences 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, however, additional functions are being performed by the tested party, then it may be necessary to determine an appropriate additional return to such function and permit a separate return for these additional functions. Similarly, if the comparables perform functions not performed by the tested party, then the return for such functions should be subtracted from the gross profit margin applied to the controlled transactions of the tested party;

- Careful consideration should be given to what costs should be excluded from the cost 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 calculated uniformly by the associated enterprise and the independent enterprises;
- Historical costs should in principle be ascribed to individual units of production. If costs differ over a period, average costs over the period may be used;
- One can use either budgeted cost or actual cost in applying the Cost Plus Method. On the one hand using actual costs will better reflect the risks faced by the contract manufacturer.⁵⁶ 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 between the manufacturer or service provider and the purchaser of goods or services.

⁵⁶Note 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.

6.2.19. Strengths and Weaknesses

6.2.19.1. 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.

6.2.19.2. 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.

6.2.20. When to Use the Cost Plus Method

6.2.20.1. The Cost Plus Method is typically applied in cases involving 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.

6.2.20.2. The Cost Plus Method is also generally used in transactions involving a contract manufacturer, a toll manufacturer or a low risk assembler which does not own product intangibles and 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 production, 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.

6.2.20.3. 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.

6.2.21. Case Examples of Cost Plus Method

6.2.21.1. 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 uncontrolled 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.

6.2.21.2. Example 2

The facts are the same as in Example 1 except that LCO accounts for supervisory, general, and administrative costs as operating expenses, which are not allocated to its sales to FS. The gross profit mark-ups of

UT1, UT2, and UT3, however, reflect supervisory, general, and administrative expenses because they are accounted for as costs of goods sold. Accordingly, the gross profit mark-ups of UT1, UT2, and UT3 must be adjusted to provide accounting consistency. If data is not sufficient to determine whether such accounting differences exist between the controlled and uncontrolled transactions the reliability of the results will decrease.

6.2.21.3. 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 reasonably ascertain the effect of the difference on the gross profit mark-ups will affect the reliability of the results of UT1, UT2, and UT3.

6.2.21.4. Example 4

FS, a foreign corporation, produces apparel for PCO, its parent corporation. FS purchases its materials from unrelated suppliers and produces the apparel according to designs provided by PCO. The local taxing authority identifies ten uncontrolled foreign apparel producers that operate in the same geographic market and are similar in many respects to FS.

Relatively complete data is available regarding the functions performed and risks borne by the uncontrolled producers. In addition, data is sufficiently 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

inability to determine whether differences exist between the controlled and uncontrolled transactions will diminish the reliability of these results. Therefore, the reliability of the results of the uncontrolled transactions must be enhanced.

6.3. Transactional Profit Methods

6.3.1. Introduction

6.3.1.1. This part of the chapter discusses transactional profit methods, which analyse 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 categories; the Transactional Net Margin Method (TNMM) and the Profit Split Method (PSM).

6.3.1.2. These methods differ from traditional methods in that the analysis is not necessarily based on particular comparable uncontrolled transactions involving identical or perhaps even broadly comparable products. Often, and depending on the facts and circumstances, the analysis is based on the net return (the earnings determined before interest and tax and extraordinary items, i.e. EBIT) realized by various companies engaged in a particular line of business (that is, a series of transactions that are appropriate to be aggregated). Among other situations, 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 associated enterprises and the appropriate return for the use of those intangible assets must be determined.

6.3.1.3. It is rare that enterprises use transactional profit methods to actually determine their prices. However the profit resulting from a controlled transaction might be quite a good signal to establish whether the transaction was affected by conditions that differ from those that would have been made by independent enterprises in otherwise comparable circumstances. Where complexities make the application of the traditional transaction methods addressed in the previous chapter unreliable, transactional profit methods may prove to be a good solution.

6.3.1.4. Transactional profit methods and particularly the Transactional Net Margin Method are also commonly used by taxpayers 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 methods. It is also easier to find comparables in applying the Transactional Net Margin Method.

6.3.2. Transactional Net Margin Method

6.3.2.1. The TNMM examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that are appropriate to be aggregated). The profit margin indicators are discussed below. The TNMM looks at the profits of one of the related parties involved in a transaction, as do the Cost Plus Method and Resale Price Method. The party examined is referred to as the tested party.

6.3.2.2. The TNMM compares the net profit margin⁵⁷ (relative to an appropriate base) that the tested party earns in the controlled transactions to the same net profit margins earned by the tested party in comparable uncontrolled transactions or alternatively by independent comparable companies. As it uses net margins to determine arm's length prices the TNMM is a less direct method than the 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.

6.3.2.3. The TNMM is used to analyse transfer pricing issues involving tangible property, intangible property or services. It may be applied when one of the associated enterprises employs intangible assets, the appropriate return to which cannot be determined directly. In such a case the arm's length compensation of the associated enterprise(s) not employing the intangible asset is determined by determining the margin realized by enterprises engaged in a similar function with unrelated parties. The remaining return is consequently left to the

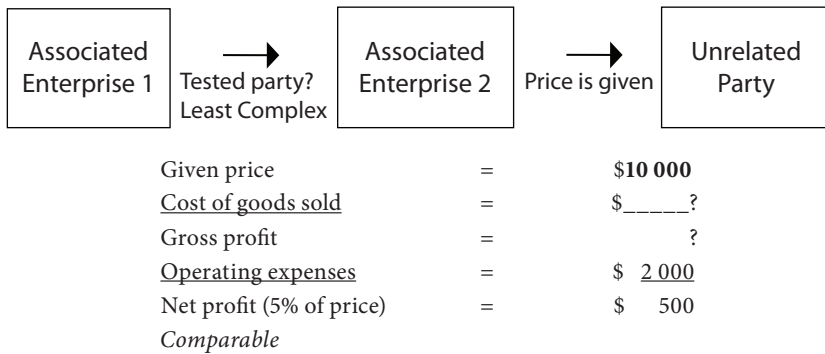
⁵⁷For example, return on total costs, return on assets, and operating profit to net sales ratio.

associated enterprise controlling the intangible asset. The return to the intangible asset is, in practice, a “residual category” being the return left over after other functions have been appropriately compensated at arm’s length. This implies that the TNMM is applied to the least complex of the related parties involved in the controlled transaction. This approach has the added benefit that generally more comparable data are available and fewer adjustments are required to account for differences in functions and risks between the controlled and uncontrolled transactions. In addition, the tested party typically does not own valuable intangible property.

6.3.3. Definition and Choice of Tested Party

6.3.3.1. The application of the TNMM is similar to the application 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 6.4 below and the rest of this section illustrates this distinction.⁵⁸

Figure 6.4: Transactional Net Margin Method



Associated Enterprise 1, a bicycle manufacturer in Country 1, sells bicycles to Associated Enterprise 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2. Assume that Associated Enterprise 1 is the more complex party, controlling a variety of technology and operating intangibles. The CUP

⁵⁸All figures and numeric examples are for practical purposes only. They do not reflect actual cases or actual arm’s length figures or margins.

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.

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

6.3.3.3. Sometimes it may be more reliable to choose the TNMM and compare net profits. If, for example, there is different reporting of the cost of goods sold and operating expenses for the tested party and the comparable distributors, so that the gross profit margins reported are not comparable and reliable adjustments cannot be made, the 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.

6.3.3.4. The application of the TNMM would entail an analysis of the least complex party — in this case the distributor. Such an analysis would entail a search for comparable distributors taking into account the comparability standard of this method. An application of the TNMM focusing on 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 manufacturing

function. The Cost Plus Method would normally be considered if the CUP Method cannot be applied. However, due to the accounting inconsistency mentioned above, it may be appropriate to apply the TNMM using a financial ratio based on net profit margin that is appropriate for a manufacturer (e.g. return on total costs).

6.3.4. Mechanism of the Transactional Net Margin Method

6.3.4.1. The next question is how to determine the transfer price based on the application of the TNMM? The mechanism of the TNMM is similar to the mechanisms of the Resale Price Method and Cost Plus Method as can be seen in the following examples.

6.3.4.2. 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 variable. Assuming a resale price of \$10,000 and a gross profit margin of 25 per cent, the transfer price amounts to \$7,500:

Table 6.1: 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)

6.3.4.3. 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 calculating the transfer price. In applying the TNMM to the tested party distributor the resale price and the operating expenses of the related party distributor are known, while the arm’s length net profit margin (i.e. net profit to sales ratio)⁵⁹ is found on the basis of a benchmarking analysis. The cost of goods sold and the gross profit are the unknown variables.

⁵⁹Net profit equals operating profit before interest and taxes.

Assuming a resale price of \$10,000, operating expenses of \$2,000 and an arm's length net profit margin of 5 per cent, using the TNMM the transfer price of \$7,500 is determined by working backwards using the available information. That is, a transfer price of \$7,500 is required to ensure that the distributor earns a net profit margin of 5 per cent:

6.3.4.4. 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 transfer price or sales revenue of the related party manufacturer is the unknown variable. Assuming cost of goods sold of \$5,000 and a gross profit mark-up of 50 per cent, the transfer price amounts to \$7,500:

Table 6.2: 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)

Table 6.3: 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)

6.3.4.5. In applying the TNMM to the tested party manufacturer instead of the Cost Plus Method, the cost of goods sold and the operating expenses of the related party manufacturer are known. A benchmarking analysis will determine the arm's length net profit of the related party manufacturer using a profit level indicator such as the ratio of net profit to total cost. The sales price and the gross profit are the unknown variables. Assuming cost of goods sold of \$5,000, operating expenses of \$1,000 and an arm's length net profit to total cost ratio

of 25 per cent, the transfer price amounts to \$7,500. Table 6.4 illustrates that working backwards using the available information leads to the determination that the sales price (i.e. transfer price in this case) is \$7,500.

Table 6.4: 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)

6.3.5. Examples⁶⁰

6.3.5.1. Example 1: Transfer of Tangible Property Resulting in No Adjustment

FP is a publicly traded Country A corporation with a Country B subsidiary named BCO that is under audit for its 2009 taxable year. FP manufactures a consumer product for worldwide distribution. BCO imports the assembled product and distributes it within Country B at the wholesale level under the FP name.

FP does not allow uncontrolled taxpayers to distribute the product. Similar products are produced by other companies but none of them is sold to uncontrolled taxpayers or to uncontrolled distributors.

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.

There is data from a number of independent operators of wholesale distribution businesses. These potential comparables are further narrowed to select companies in the same industry segment that perform similar

⁶⁰The examples below derive from the US Internal Revenue Service Intercompany Transfer Pricing Regulations. The Manual will include examples from developing countries in the next edition.

functions and bear similar risks to BCO. An analysis of the information available on these taxpayers shows that the ratio of operating profit to sales is the most appropriate profit level indicator, and this ratio is relatively stable where at least three years are included in the average. For the taxable years 2007 to 2009, BCO shows the following results:

	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

After adjustments have been made to account for identified material differences between BCO and the uncontrolled distributors, the average ratio of operating profit to sales is calculated for each of the uncontrolled distributors. Applying each ratio to BCO would lead to the 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 is within this range.

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

6.3.5.2. Example 2: Transfer of Tangible Property Resulting in an Adjustment

The facts are the same as in Example 1 except that BCO reported the following income and expenses:

	2007	2008	2009	Average
Sales	\$500 000	\$560 000	\$500 000	\$520 000
COGS	370 000	460 000	400 000	410 000
Operating expenses	110 000	110 000	110 000	110 000
Operating profit	20 000	(10 000)	(10 000)	0

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 comparables 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

6.3.5.3. 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 average results from the uncontrolled comparables and average sales for BCO for the years 2008 to 2010, ranges from \$15,500 to \$30,000. In determining whether an 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 operating profits over this period. BCO's average reported operating profit is determined without regard to the adjustment made with respect to the 2009 taxable year. Therefore, BCO's average reported operating profit for the years 2008 to 2010 is (\$10,000). Because this amount of income falls outside the interquartile range, the tax authority determines that an 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 operating profits derived from the uncontrolled distributors' results for 2010. The median of the comparable operating profits derived from the uncontrolled comparables results for the 2010 taxable year is \$12,000. Based on this comparison, the taxing authority increases BCO's 2010 taxable income by \$22,000, the difference between the median of the comparable operating profits for the 2010 taxable year and BCO's reported operating profit of (\$10,000) for the 2010 taxable year.

6.3.5.4. 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 examines whether the royalty rate of 5 per cent paid by HCO to DCO is an arm’s length consideration for the HTP technology.

Based on all the facts and circumstances the taxing authority determines that the TNMM will provide the most reliable measure of an arm’s length result. HCO is selected as the tested party because it engages in relatively routine manufacturing activities, while DCO engages in a variety of complex activities using unique and valuable intangibles. Finally, because HCO engages in manufacturing activities, it is determined that the ratio of operating profit to operating assets is an appropriate profit level indicator.

Uncontrolled taxpayers performing similar functions cannot be found in Country H. It is determined that data available in Country M and N provide 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 uncontrolled comparables and to make adjustments to account for such differences. 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

	2007	2008	2009	Average
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).

6.3.5.5. 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 identified.

MCO has a significantly lower level of accounts receivable than the uncontrolled manufacturers. Since the rate of return on capital employed is used as the profit level indicator, both operating assets and operating profits must be adjusted to account for this difference. Each uncontrolled comparable's operating assets is reduced by the amount (relative to sales) by which they exceed MCO's accounts receivable. Each uncontrolled comparable's operating profit is adjusted by deducting imputed interest income on the excess accounts receivable. This imputed interest income is calculated by multiplying each uncontrolled comparable's excess accounts receivable by an interest rate appropriate for short-term debt.

6.3.5.6. 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.

6.3.7. Arm's Length Net Profit Margin

6.3.7.1. 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 6.5: Overview of Profit Level Indicators

Return on Assets (ROA)	Operating profit divided by the operating assets (normally only tangible assets)
Return on Capital Employed (ROCE)	Operating profit divided by capital employed which is usually computed as the total assets minus cash and investments
Operating Margin (OM)	Operating profit divided by sales
Return on Total Costs (ROTC)	Operating profit divided by total costs
Return on Cost of Goods Sold	Gross profit divided by cost of goods sold
Berry Ratio	Gross profit divided by operating expenses

6.3.7.2. Key Definitions:

- **Gross profit** is arrived at by deducting from the total sales the cost of sales, including all the expenses directly incurred in relation to those sales;
- **Operating profit** or operating income is the income of a company net of direct and indirect expenses but before deduction for 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 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.

6.3.7.3. Although all of the above PLIs are possible, the three PLIs: (i) return on capital employed (ROCE) (ii) operating margin (OM) and (iii) return on total cost (ROTC) are most used in practice. The Berry Ratio may also be used, but subject to certain concerns about its inappropriate use.⁶¹ 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 typically used for manufacturing activities. The ROA and ROCE divide operating profit by a balance sheet figure. These PLIs are based on assets actively employed in the business. Such tangible assets consist of all assets minus investments (e.g. in subsidiaries), minus cash and cash equivalents beyond the amount needed for working capital. In the case of the ROA a deduction is also made for intangible assets such as

⁶¹For 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 perform other significant functions in the transaction under examination that should be remunerated using another method or profit level indicator.

goodwill. These two PLIs may, for example, be used for leasing companies. This type of PLI may be the most reliable if the tangible operating assets have a high correlation to profitability. For example a manufacturer's operating assets such as property, plant, and equipment could have more impact on profitability than a distributor's operating assets, since often the primary value added by a distributor is based on services it provides and these are often less dependent on operating assets. The difference between the ROA and the ROCE is that the ROA focuses on the assets used while the ROCE focuses on the amount of debt and equity capital that is invested in the company.

6.3.7.4. Other PLIs listed above are ratios between income statement items. PLIs based on income statement items are often used when fixed assets do not play a central role in generating operating profits. This is often the case for wholesale distributors and service providers. Operating margin has often been used when functions of the tested party are not close to those of the comparables, since differences in function have less effect on operating profit than on gross profit.

6.3.7.5. The Berry Ratio represents a return on a company's value added functions on the assumption that these value added functions 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 operating expenses. Consequently it may be appropriate to use the Berry Ratio if the selling or marketing entity is a service provider entitled to a return on the costs of the provision of its services. 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 property of an entity; and
- Its reliability diminishes if asset intensities (the efficiency with which assets are used) of the entities differ

6.3.7.6. In general the gross margin has not been favoured as a PLI because the categorization of expenses as operating expenses or cost of goods sold may be somewhat arbitrary or even subject to manipulation, making comparisons between the tested party and comparables difficult or impossible.

6.3.7.7. The choice of PLI depends on the facts and circumstances of a particular case. Thus it may be useful to consider multiple PLIs. If the results tend to converge, that may provide additional assurance that the result is reliable. If there is, on the other hand, a broad divergence between the different PLIs it may be useful to examine important functional or structural differences between the tested party and the comparables.

6.3.8. Transactional Comparison Versus Functional Comparison

6.3.8.1. 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 independent companies performing functions and incurring risks comparable to those of the tested party.

6.3.8.2. Much more detailed information will be available with respect to the controlled and uncontrolled transactions if a transactional comparison is possible, because the related parties involved have participated in these transactions. The degree of comparability can then be analysed more carefully than in a functional comparison in which only public information is available (e.g. business descriptions in a database, annual reports and Internet data). This may imply that the reliability of transactional comparisons will be higher than that of functional comparisons in practice. In fact if sufficient data exist to reliably apply a TNMM based on a transactional comparison it may be possible to apply a traditional transaction method.

6.3.8.3. However, functional comparison will be more often used in practice as the data necessary for functional comparison may be available whereas the data needed for transactional comparison is not. Let us assume that a related party distributor is the tested party in the example presented in Table 6.6. The TNMM is applied and the profit level indicator is the operating margin. A benchmarking analysis is performed, identifying four comparable independent distributors considering the comparability standard of the TNMM. The arm's length range of operating margin earned by these comparable distributors falls between 2 per cent and 6 per cent. Because the operating profit margin earned by the related party distributor falls within this range (e.g. 4 per cent), its transfer price is considered to be at arm's length.

Table 6.6: 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%

6.3.9. Comparability

6.3.9.1. 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 dependent on product comparability and focus on functional comparability because differences in functions that are reflected in differences in operating expenses may lead to a broad range of gross margins. However, the TNMM is even less dependent on product comparability and functional comparability than the traditional transaction methods, because net margins are less influenced by differences in products and functions. The TNMM focuses on broad product and functional comparability.

6.3.9.2. 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.

6.3.9.3. Specific factors that may affect net margins include, but are not limited to:

- Barriers to entry in the industry;
- Competitive position;
- Management efficiency;
- Individual business strategies;
- Threat of substitute products;
- Varying cost structures (e.g. the age of plant and equipment); and
- The degree of business experience (e.g. start-up phase or mature business).

If material differences between the tested party and the independent enterprises are affecting the net margins, reasonably accurate adjustments should be made to account for such differences.


6.3.10. Other Guidance for Application of the Transactional Net Margin Method

6.3.10.1. The TNMM is less reliable when applied to the aggregate activities of a complex enterprise engaged in various different transactions or functions. The method should be used to analyse only the profits of the associated enterprise that are attributable to simpler controlled transactions or functions. The TNMM should thus generally not be applied on a company-wide basis if the company is involved in a number of different controlled transactions or functions which are not properly evaluated on an aggregate basis. However, it may be possible to apply TNMM when the aggregate activities/transactions are sufficiently interlinked, as for example when similar sales functions are conducted for products in similar product lines.

6.3.10.2. The TNMM should be applied using transactions or functions of independent enterprises that are comparable to the controlled transactions or functions being examined. Furthermore, results attributable to transactions between the tested party and independent enterprises should be excluded when evaluating controlled transactions. The latter point is illustrated in Table 6.7 below. In this example, the Related Party Distributor purchases products from both the Related Party Manufacturer and an Unrelated Manufacturer and resells these products to customers. The tax authorities in the country of the Related Party Distributor apply the TNMM to determine whether the transfer prices of the Related Party Distributor are at arm's length. A benchmarking study performed by the tax authorities shows that comparable distributors earn an operating profit margin between two and six per cent.

6.3.10.3. The tax authorities apply the TNMM to the profit and loss statement (P&L) of the Related Party Distributor as a whole. The operating profit margin earned by Related Party Distributor is two per cent 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 three per cent, 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.

Table 6.7: 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

Consistency is important in quantifying these amounts. Net margins should be calculated uniformly between the tested party and the independent enterprises.

6.3.10.4. 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. However different countries may take different views about when multiple year data should be analysed 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 differences between the controlled and uncontrolled entities. However the use of a range may not sufficiently take into account circumstances where the profits of a taxpayer are affected by a factor unique to that taxpayer.

6.3.11. Strengths and Weaknesses of the TNMM

6.3.11.1. 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 margins. 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 transaction (i.e. to either the related party manufacturer or the distributor); and
- The results resemble the results of a modified Resale Price Method or Cost Plus Method of analysis.

6.3.11.2. 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 information on profits attributable to uncontrolled transactions;
- Measurement challenges, these may make it difficult to determine sales revenue, operating expenses and assets relating only to the relevant controlled transactions or functions in order to calculate the selected profit level indicator. For example, if a related party distributor purchases products from both a related party and an unrelated enterprise for resale it may be impossible to determine sales revenue, operating expenses and assets attributable to only the controlled transactions to reliably perform a net margin method of analysis. Furthermore, if the companies are engaged in different activities it 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.

6.3.12. When to Use the Transactional Net Margin Method

6.3.12.1. TNMM is usually applied with respect to broad comparable functions rather than particular controlled transactions. Returns to these functions are typically measured by a PLI in the form of a net margin that arguably will be affected by factors unrelated to arm's length pricing. Consequently, one might expect the TNMM to be a relatively disfavoured method. Nevertheless TNMM is 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 functions 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.

6.3.12.2. TNMM may also be appropriate for use in certain situations in which data limitations on uncontrolled transactions make it more reliable than traditional methods. TNMM may be more attractive if the data on gross margins are less reliable due to accounting differences (i.e. differences in the treatment of certain 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 analyse net margins, a more consistent measured profit level indicator than gross margins in case of accounting differences.

6.3.12.3. Consider the example in Table 6.8 below, where the related party distributor earns a gross profit margin of 20 per cent while the comparable distributor earns a gross profit margin of 30 per cent. Based on the 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.

6.3.12.4. For example it may be the case that the related party distributor treats warranty costs as cost of goods sold while the comparable distributor treats such costs as operating expenses. If the warranty costs of the comparable distributor can be identified precisely, then appropriate adjustments on the gross profit level can be made. In practice, however, such detailed information about independent enterprises cannot be obtained from publicly available information. It may then be more appropriate to perform a net margin method of analysis where such accounting inconsistency has been removed. The result of applying the TNMM is that the net profit margin of 10 per cent for the related party distributor is similar to that of the comparable distributor. The transfer price is therefore considered to be at arm's length based on the TNMM.

6.3.12.5. 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 appropriate 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 product and functional comparability. In such a case the TNMM might be more reliably applied using such comparables.

Table 6.8: Accounting Differences: The Resale Price Method as Compared with the Transactional Net Margin Method

	Related Party Distributor	Comparable Distributor
Selling price	100	100
<u>Cost of goods sold</u>	<u>80</u>	<u>70</u>
Gross profit	20	30
<u>Operating expenses</u>	<u>10</u>	<u>20</u>
Operating profit	10	10

6.3.12.6. 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.

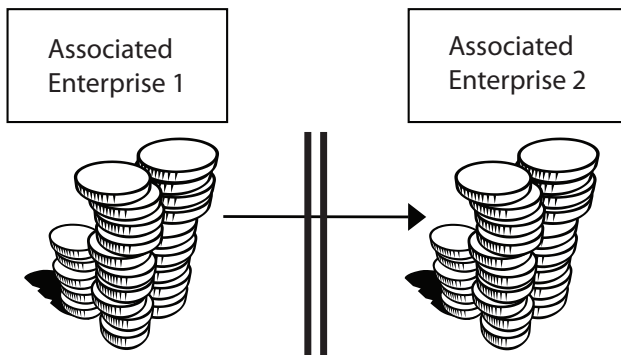
6.3.12.7. In addition to the three situations mentioned above, the TNMM is also used in practice by tax authorities to identify companies for an audit by analysing their net profit margins. Furthermore, the TNMM is often applied to check and to confirm the results of traditional transactional methods. 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.

6.3.13. Profit Split Method

6.3.13.1. The Profit Split Method is typically applied when both sides of the controlled transaction contribute significant intangible property. The profit is to be divided such as is expected in a joint venture relationship.

6.3.13.2. The Profit Split Method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that it is appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions. Figure 6.5 illustrates this.

Figure 6.5: Profit Split Method



6.3.13.3. The Profit Split Method starts by identifying the profits to be divided between the associated enterprises from the controlled transactions. Subsequently, these profits are divided between the associated enterprises based on the relative value of each enterprise's contribution, 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 enterprise'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 functions performed by the associated enterprises. The Profit Split Method is applicable to transfer pricing issues involving tangible property, intangible property, trading activities or financial services.

6.3.14. Methods to Allocate or Split the Profits

6.3.14.1. There are generally considered to be two specific methods to allocate the profits between the associated enterprises: contribution analysis and residual analysis.

6.3.14.2. 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.

6.3.14.3. If the relative value of the contributions can be calculated 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.

6.3.14.4. Under the residual analysis the combined profits from the controlled transactions are allocated between the associated enterprises based on a two-step approach:

- *Step 1:* allocation of sufficient profit to each enterprise to provide 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 intangible property then the allocation of this profit should be based on the relative value of each enterprise's contributions of intangible property.

6.3.14.5. The residual analysis is typically applied to cases where both sides of the controlled transaction contribute valuable intangible property to the transaction. For example Company X manufactures 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 manufacturing function and a basic (arm's length) return to Company Y for its manufacturing and distribution functions. The residual profit remaining 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 property. 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.

6.3.14.6. The following approaches have been specified in some jurisdictions to determine the relative value of each company's contributions 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;⁶² 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 roughly similar.

6.3.14.7. 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 analyses returns to often unique intangible assets based not on comparables but on relative value which is, in many cases, a practical solution. Secondly, potential conflict with the tax authorities is reduced by using the two-step residual approach since it reduces the amount of profit that is to be split in the potentially more controversial second step.

6.3.15. Comparable Profit Split Method

6.3.15.1. A different version of the Profit Split Method is used in some countries. In this version the profit is split by comparing the allocation of operating profits between the associated enterprises to the allocation of operating profits between independent enterprises participating in similar activities under similar circumstances (Comparable Profit Split Method). The major difference with the contribution analysis is that the Comparable Profit Split Method depends on the availability 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.

6.3.15.2. 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

⁶²A disadvantage of this approach is that cost may not reflect the market value of the intangible property.

necessary to split the combined profits between the associated enterprises are often not available.

6.3.16. Strengths and Weaknesses

6.3.16.1. 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 inappropriate 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 parties to the controlled transaction are being analysed); 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.

6.3.16.2. The weaknesses of the Profit Split Method include:

- The relative theoretical weakness of the second step. In particular, 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 difficulty 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 controlled transactions due to, for example, differences in accounting practices. It may also be hard to allocate costs and operating expenses between the controlled transactions and other activities of the associated enterprises.

6.3.17. When to Use the Profit Split Methods

6.3.17.1. The Profit Split Method might be used in cases involving highly interrelated transactions that cannot be analysed on a separate 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 separate basis using a traditional transaction method. In other words, the transactions are so interrelated that it is impossible to identify comparable transactions. In this respect, the Profit Split Method is applicable in complex industries such as, for example, the global financial services business.

6.3.17.2. The (Residual) Profit Split Method is typically used in complex cases where both sides to the controlled transaction own valuable intangible property (e.g. patents, trademarks and trade names). If only one of the associated enterprises owns valuable intangible property, the other associated enterprise will be the tested party in an analysis 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.

6.3.17.3. In step 1 of the residual analysis, a basic return for the manufacturing function is determined for Company A and Company B. 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 relative 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.

6.3.17.4. 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 available. 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.

6.3.18. Examples: Application of Residual Profit Split

(i) XYZ is a corporation that develops, manufactures and markets a line of products for use by the police in Country A. XYZ's research unit developed a bulletproof material for use in protective clothing and head-gear (Stelon). XYZ obtains patent protection for the chemical formula for Stelon. Since its introduction, Stelon has captured a substantial share of the market for bulletproof material.

(ii) 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.

(iii) XYZ-Asia's research unit alters Stelon to adapt it to military specifications and develops a high-intensity marketing campaign directed at the defence industry in several Asian countries. Beginning with the 2009 taxable year, XYZ-Asia manufactures and sells Stelon in Asia through its marketing network under one of its brand names.

(iv) 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 reliable 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 average market return on XYZ-Asia's operating assets in the Stelon business is 10 per cent, 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.

(v) 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 formula (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.

(vi) As XYZ's protective product research and development expenses support the worldwide protective product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide business activities to which they relate. 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.

(vii) 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.

(viii) 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.

Chapter 7

DOCUMENTATION

7.1. Introduction

7.1.1. Adequate documentation will make it easier for tax authorities to review a taxpayer's transfer pricing analysis and thereby contribute to avoiding a dispute or to a timely resolution of any transfer pricing disputes that may arise. Adequate documentation is characterized by (i) the sufficiency of the details demonstrating the taxpayers' compliance with the arm's length principle as well as (ii) the timely manner in which such details are prepared and submitted to tax authorities.

7.1.2. A taxpayer should make reasonable efforts to undertake an adequate transfer pricing analysis to establish the arm's length pricing, as well as to show clearly that such analysis has been actually conducted. Activities undertaken to prepare and maintain appropriate documents with a view to conforming to the arm's length principle can be referred to as "arm's length documentation".

7.1.3. This chapter first introduces some existing international guidelines on transfer pricing documentation, which will be helpful in explaining general issues on documentation. It is then followed by a more in-depth discussion on several topical issues frequently raised in the process of transfer pricing documentation, with the goal of providing practical guidance on such issues. Appendix II of this Manual provides, at Part B, selected countries' legislation on transfer pricing documentation.

7.2. International Guidelines on Transfer Pricing Documentation

7.2.1. OECD Transfer Pricing Guidelines

7.2.1.1. The OECD's guidance on documentation is summarized in the following paragraphs of the OECD Transfer Pricing Guidelines.

“5.28 Taxpayers should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm’s length principle. Tax administrations should have the right to obtain the documentation prepared or referred to in this process as a means of verifying compliance with the arm’s length principle. However, the extensiveness of this process should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. Moreover, the need for the documents should be balanced by the costs and administrative burdens, particularly where this process suggests the creation of documents that would not otherwise be prepared or referred to in the absence of tax considerations. Documentation requirements should not impose costs and burdens on taxpayers that are disproportionate to the circumstances. Taxpayers should nonetheless recognize that adequate record-keeping practices and voluntary production of documents facilitate examinations and the resolution of transfer pricing issues that arise.

5.29 Tax administrations and taxpayers alike should commit themselves to a greater level of cooperation in addressing documentation issues, in order to avoid excessive documentation requirements while at the same time providing for adequate information to apply the arm’s length principle reliably. Taxpayers should be forthcoming with relevant information in their possession, and tax administrations should recognize that they can avail themselves of exchange of information articles in certain cases so that less need be asked of the taxpayer in the context of an examination [...].”

7.2.1.2. The key points from this guidance can be summarized as follows:

- Taxpayers should make **reasonable efforts** at the time of the transfer pricing to prepare and maintain transfer pricing documentation — this is not to say that they need to *provide* the information to tax authorities at that time — whether that is the case ultimately depends on domestic law;

- Tax administrations **should have the right to obtain taxpayers' documentation** prepared in the process of the taxpayers' establishment of transfer pricing;
- However, the governing principle for the transfer pricing documentation should be "**prudent business management principles**". Therefore, a tax administration should display understanding of the extent to which that information could reasonably be expected to have been available to the taxpayer at the time a transfer price was established;
- A tax administration's **need for documents should be balanced by the costs** and administrative burdens of providing such documentation by a taxpayer;
- Tax administrations and taxpayers should **try to cooperate with each other** with a view to maintaining effective operation of the transfer pricing documentation regime;
- Tax administrations should try to use **exchange of information provisions** of tax treaties to the extent possible, especially in relation to information not readily available to the taxpayer.

7.2.1.3. It is of course recognized that most non-OECD countries do not have the extensive treaty networks that OECD countries have, and will often have to rely upon taxpayers providing information for this reason.

7.2.1.4. Under the OECD Guidelines, the following types of information, among others, should be made available through documentation, although it is neither a minimum compliance list nor an exclusive list of relevant information:

- Information about the **associated enterprises** involved in the controlled transactions and independent enterprises engaged in similar transactions;
- Information regarding the **nature and terms of the controlled transactions**, economic conditions and property involved in such transactions, product or service flows and changes in trading conditions or renegotiations of existing arrangements;

- Description of the circumstances of any known **transactions between the taxpayer and an unrelated party** that are similar to the transaction with the foreign associated enterprise, and therefore might function as an arm's length comparison;
- Outline of the **business structure** of the organization, including the associated enterprises and ownership linkages within the MNE group;
- Information about the amount of **sales and operating results** of the associated enterprises from the last few years preceding the transaction; and
- Information on **pricing**, including business strategies and special circumstances that may be relevant, such as a “set-off” arrangement whereby the buyer provides the seller some services as part of the transaction.

7.2.1.5. Such information will help evaluate the **functions** performed by the associated enterprises, the **assets** used in doing this, and the **risks assumed** by the parties to the transaction, all of which will be important to a functional analysis of the type discussed in Chapter 5 of this Manual.

7.2.2. Documentation Rules of the Pacific Association of Tax Administrators

7.2.2.1. In 2003, the Pacific Association of Tax Administrators (PATA), which is comprised of tax administrations from Australia, Canada, Japan and the US, announced its “Transfer Pricing Documentation Package” (the Package). The Package provides for a harmonized documentation procedure among PATA member states.⁶³

- Taxpayers that choose to use the Package, which is voluntary and aimed at avoiding penalties for documentation, must meet the three following requirements:

⁶³Pacific Association of Tax Administrations, “Transfer Pricing Documentation Package”, March 2003. Available from <http://www.nta.go.jp/kohyo/katsudou/shingi-kenkyu/kokusai020617/pdf/01.pdf>

1. Make reasonable efforts to establish arm's length prices;
2. Maintain contemporaneous documentation of their efforts to comply with the arm's length principle; and
3. Produce, in a timely manner, documentation upon request by a PATA member tax administrator.

7.2.2.2. The Package seeks to respond to the potential difficulties that MNEs face in complying with the laws and administrative requirements of multiple tax jurisdictions. It is intended to be consistent with the general documentation principles of the OECD Guidelines.

7.2.2.3. While the Package is meant to give greater certainty to taxpayers, it has sometimes been criticized as doing so at the expense of expanding the required documentation. The PATA guidelines do not impose higher documentation requirements than those set forth in any PATA member's laws. The Package is however considered to impose significant requirements, which are perceived to be greater than those in any particular member country.⁶⁴ It essentially requires compliance with the domestic laws of all the PATA countries to ensure that a penalty will not be applicable in one particular PATA jurisdiction.

7.2.2.4. The PATA guidelines should not be seen as a template for other countries' documentation requirements. Their greatest usefulness is perhaps that they form a compendium of local documentation requirements in the four PATA countries that may be a useful reference point for countries setting up a transfer pricing system.

7.2.2.5. The Package has also been criticized in that it contains no guidance as to the nature of the comparable transactions (which would depend on the law of the PATA countries). In other words, no guidance is provided as to whether local comparables must be used, or whether some form of blended (foreign with local elements) comparable is required. As noted in Chapter 5 on Comparability Analysis, however, the reality is that for most developing countries, there will be no

⁶⁴For example, in Australia, there is no apparent requirement to keep transfer pricing documentation in its tax law or regulations. However, taxation ruling TR98/11 recommends contemporaneous documentation to evidence compliance with arm's length principle to reduce the risk of an audit and to mitigate penalties in the event of an audit adjustment.

local comparables, and some form of adjustment to foreign comparables will often be necessary. As many developing countries do not have access to databases that allow identification of foreign comparables, and may have limited analytical resources to adjust those comparables for local conditions, it will be very important that the comparables relied on by a taxpayer are well documented, with strong legal incentives (including strong penalty provisions to discourage provision of inaccurate information).

7.2.2.6. Further, the Package requires extensive documentation on organizational structure, nature of business (industry) and market conditions, controlled transactions, assumptions, strategies or policies, comparability, functional and risk analysis, selection and application of the transfer pricing method, details on cost contribution arrangements, background documents and an index of the documents provided.

7.2.3. The European Union Code of Conduct on Transfer Pricing Documentation

7.2.3.1. In 2006, the European Council adopted a Code of Conduct on Transfer Pricing Documentation for associated enterprises in the EU (the Code) in order to reduce the compliance costs of having to comply with different rules in each individual country. According to the Code, taxpayers can avoid transfer pricing documentation penalties imposed by EU member countries if they maintain (i) a masterfile of standardized information and (ii) a country-specific file of standardized information for each EU member country in which the taxpayer has related-party transactions.⁶⁵

7.2.3.2. Centralizing and standardizing documentation for centralized MNE groups is very likely to reduce their compliance burdens. The Code itself does not require contemporaneous documentation but, in practice, files should be prepared contemporaneously if a national law so requires.

⁶⁵European Council, “Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in the European Union (EU TPD)”, June 2006. Available from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:176:0001:0007:EN:PDF>

7.2.3.3. An EU Member State may decide not to require transfer Pricing documentation at all or to require a shorter version of the EU transfer pricing documentation, i.e. require fewer items in the masterfile or the country-specific documentation. However, a Member State should not require *more* items in the masterfile or the country-specific documentation.

7.2.3.4. The Code also provides that translation to other languages would only be provided upon request and translation should not be required unless necessary in the circumstances. The Code seems particularly to deter countries from seeking translation of the masterfile. The Code also provides that EU Member States should not automatically reject comparables found in pan-European databases. Therefore, the use of non-domestic comparables by itself should not subject the taxpayer to penalties for non-compliance.

7.2.3.5. The masterfile provides a blueprint of the company and its transfer pricing system that would be relevant for all EU Member States concerned. The masterfile should contain general descriptions of the group's business strategy, organizational structure, general description of the controlled transactions involving associated enterprises in the EU, functions performed and risks assumed by enterprises, ownership of intangibles, group's inter-company transfer pricing policy and a list of cost contribution agreements, APAs and transfer pricing rulings, etc.

7.2.3.6. The country-specific documentation, on the other hand, should contain a detailed description of the taxpayer's business strategy, information on country-specific controlled transactions, a comparability analysis, selection and application of the transfer pricing method, internal or external comparables, etc. However, the basic set of information for the assessment of a multinational enterprise group's transfer prices is optional for the MNE.

7.2.4. Possible Lessons from Existing International Guidelines on Documentation

7.2.4.1. The international guidelines above were designed by developed countries in the context of their own transfer pricing legislation, priorities and capabilities. They cannot automatically be assumed to

be relevant in every respect to developing countries. It is worthwhile to examine these guidelines from the perspective of how they may work in practice in a developing country context, bearing in mind the information, analytical (including IT) and skills gaps that may exist between the tax administration and the MNE.

7.2.4.2. The essence of the OECD Transfer Pricing Guidelines with regard to transfer pricing documentation can be described as follows:

- Taxpayers are required to prepare or obtain documents necessary to allow a reasonable assessment of whether they have complied with the arm's length principle;
- The extensiveness of transfer pricing documentation should be balanced between the need for the taxpayer to demonstrate compliance with the arm's length principle and the additional costs to be incurred in preparing the required documentation;
- Taxpayers should thus not be expected to go to such lengths that compliance costs for the preparation of documentation are disproportionate to the amount of tax revenues at risk or to the complexity of the transactions.

7.2.4.3. The documentation rules of PATA and the EU's Code have common features in that both were intended to respond to difficulties taxpayers faced in complying with the laws and administrative requirements of multiple tax jurisdictions. As a result, both provide taxpayers in their jurisdictions with a documentation list so that taxpayers can avoid penalties as long as they prepare and maintain documents included in those lists.

7.2.4.4. In order for such a list to be useful for taxpayers, it should not inflict excessive burdens on taxpayers or unduly raise their compliance costs. At the same time, however, in order for such a list to be useful for tax authorities' reasonable assessment of a transfer pricing case, it should not be too superficial. In short, a balance between the tax authorities' needs and taxpayers' costs should be maintained in determining the scope and the extent of the information to be included in a mandatory documentation list, whether it is a country list or an international list adopted by a group of countries. Careful consideration must be given to striking such a balance in the design of the documentation regime, especially penalty rules, as an enforcement measure.

7.2.4.5. A disclosure form could be developed as an alternative to a list of required documentation. The disclosure form should be based on the same assumptions as mentioned above, and strike a balance between taxpayer effort required and its usefulness for tax authorities to make a proper assessment. The form should only be completed in relation to inter-company transactions of significant size. Completing the form would be sufficient to comply with documentation requirements as a full transfer pricing analysis is required to complete the form. However, a further detailed transfer pricing report may need to be produced only upon request; this should however not be required on a contemporaneous basis. The compliance burden and compliance costs for MNEs may be reduced by introducing such a form, while not compromising information available to tax authorities. An example of such a form is attached in Appendix II, Part A.

7.2.4.6. Developing countries that consider the introduction of transfer pricing documentation rules should note that European MNEs may have documentation already available due to the EU's Code of Conduct discussed above at Paragraph 7.2.3. This would include a masterfile in their parent companies (or headquarters) and a country-specific information file containing a detailed description of the business and the business strategy, information on country-specific controlled transactions, a comparability analysis and the motivation for the choice for a specific transfer pricing method.

7.3. Experiences of Multinational Enterprises with Existing International Guidelines on Documentation

7.3.1. The documentation compliance burden has increased significantly in the last decade with more and more countries introducing 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. Unfortunately countries introduce transfer pricing documentation requirements that may significantly differ per country resulting in a significant increase in compliance costs for MNEs.

7.3.2. MNEs welcome initiatives to reduce the compliance burden and the relating compliance costs by introducing standards of required

information that are relevant for multiple countries. The above mentioned international guidelines are a good starting point; however, with so many countries not covered, further harmonization is required to avoid a situation where the preparation of documentation becomes a business in itself instead of a support to the MNEs business.

7.3.3. 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 increasing focus on local comparables. As many businesses do not undergo major changes and/or restructuring every year, the added value of an annual transfer pricing report may be open to question. From an MNE perspective an annual report should not be necessary as long as there are no changes in the business practice which warrant otherwise and the relevant functional analysis is made. The outcome of any transfer pricing analysis should be made available for example in a disclosure form as described in Paragraph 7.2.4.5. Also the need for annual searches and local comparables is questionable. In many cases, the value added is negligible but the work is time consuming and requires expensive database subscriptions, or outsourcing of the work resulting in significant costs.

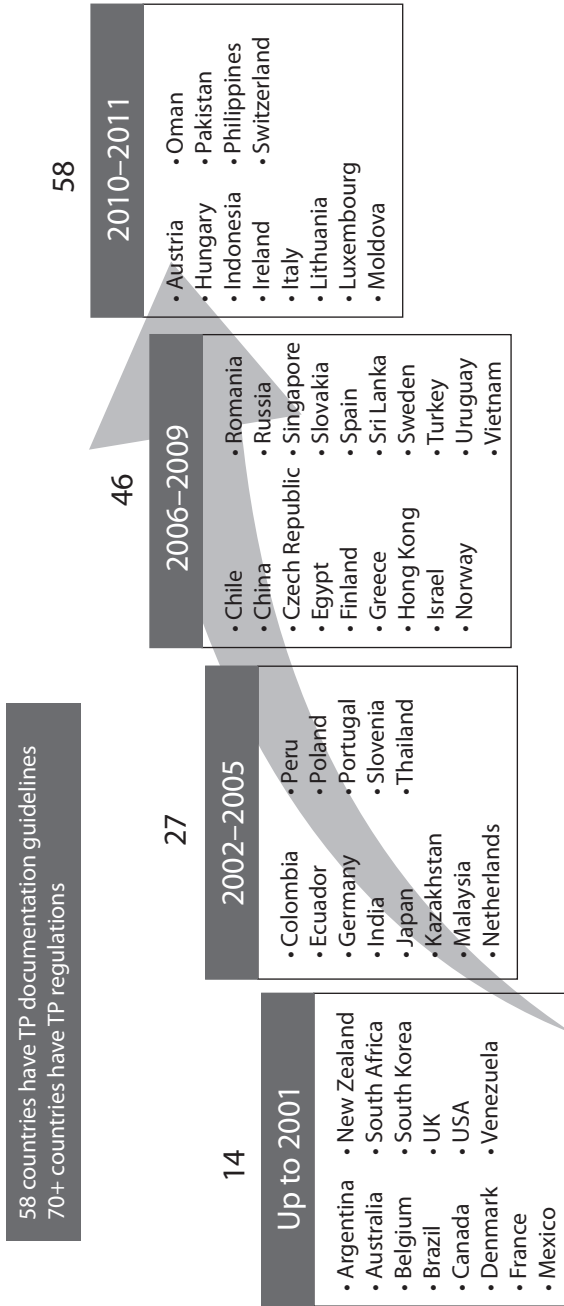
7.3.4. Instead of having very detailed transfer pricing documentation requirements that differ between countries, a general disclosure form may be developed as mentioned in Paragraph 7.2.4.5. If more consistency can be achieved with regard to information required, MNEs may develop a system that retrieves (part of) this information automatically from their financial information systems, ultimately reducing their compliance costs significantly.

7.4. Practical Guidance on Documentation Rules and Procedures

7.4.1. Burden of Proof

7.4.1.1. In most 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

Figure 7.1: Transfer Pricing Compliance Landscape



challenges taxpayers with concrete and clear reasons for such challenges. For further information consult Chapter 3, Paragraph 3.6.

7.4.1.2. However, if a country has a set of specific documentation rules in its tax law or regulations, it is generally understood that the burden of proof for the transfer price at which a taxpayer transfers goods or services with his/her related parties falls on the taxpayer, unless the taxpayer is believed to have fulfilled the obligations imposed by such documentation rules. Even where the burden of proof rests on the tax administration, the tax administration might require the taxpayer to provide documentation about its transfer pricing, because without adequate documentation, the tax administration cannot assess the case properly. In fact, where the taxpayer does not provide adequate documentation, there may be a shifting of the burden of proof in some countries in the manner of a rebuttable presumption in favour of the adjustment proposed by the tax administration.

7.4.1.3. In countries where the burden of proof generally lies with the taxpayer, the burden shifts, in most cases, to the tax administration if a taxpayer presents to the tax administration (or a court) a reasonable argument and evidence to suggest that the transfer pricing was at arm's length. Further, if specific documentation rules are already in place in such countries, the burden of proof generally shifts to the tax administration if a taxpayer has fulfilled a reasonable level of obligations required by such documentation rules.

7.4.1.4. It is therefore important that the documentation rules are broad enough to capture the reality of the related party transaction, without being excessively burdensome on the mere chance, though unlikely, that a particular piece of information may be relevant.

7.4.1.5. The burden of proof should not be misused by the tax administration or taxpayers as a justification for making assertions which may be difficult to substantiate through an ordinary level of transfer pricing documentation. In other words, both the tax administration and the taxpayer should practice good faith through reasonable documentation that their determinations on transfer pricing are consistent with the arm's length principle regardless of where the burden of proof lies.

7.4.2. Timeframe to Produce Transfer Pricing Documentation

7.4.2.1. In general, countries have different types of documentation *timing* requirements, involving one or more of the following requirements:

- Prepare information at the time of the transactions, to be submitted at the time of the filing;
- Prepare information at the time of the transactions, to be submitted upon request in case of an audit;
- Prepare information at the time of the filing;
- Prepare information only if requested upon audit; or
- No documentation requirement.

7.4.2.2. As Paragraphs 3.69 to 3.71 of the OECD Transfer Pricing Guidelines state, taxpayers, in some cases, establish transfer pricing documentation to demonstrate that they have made reasonable efforts to comply with the arm's length principle at the time their intra-group transactions were undertaken based on information that was reasonably available to them at that point, hereinafter called "arm's length price-setting" approach. Such information includes not only information on comparable transactions from previous years, but also information on economic and market changes that may have occurred between those previous years and the year of the controlled transaction. In other instances, taxpayers might 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 5, Paragraph 5.4., for a detailed discussion of this area.

7.4.2.3. A country that wishes to establish a transfer pricing documentation rule, especially the so-called "contemporaneous documentation requirements", should take into account the existence of the two pricing approaches mentioned above. When a taxpayer opts for the arm's length *outcome*-testing approach, data for external comparables are often not readily available by the year-end or by the due date of the tax return filing.

7.4.2.4. Perhaps for this reason, and because the tax authorities will not be seeking such documentation at the time the pricing is determined or the tax return is filed, the OECD Transfer Pricing Guidelines do not require contemporaneous *presentation* of documentation to the tax authorities. Since the tax administration's interest is satisfied if the necessary documents were submitted in a timely manner when requested in the course of a tax assessment, the document storage process is therefore left to the taxpayer's discretion under the OECD Transfer Pricing Guidelines.⁶⁶

7.4.2.5. Further, the OECD Transfer Pricing Guidelines provide some guidance on the amount of information to be submitted to the tax administration at the time of tax return filing. Paragraph 5.15 of the OECD Transfer Pricing Guidelines recommends limiting the amount of information requested by a tax administration at the stage of tax return filing.

7.4.2.6. The basis for this is that at the time of filing, no particular transaction has been identified for a transfer pricing review and that all that is needed at that stage is enough information to know if a further examination is needed of particular taxpayers.

7.4.2.7. The OECD Transfer Pricing Guidelines note that it would be quite burdensome if detailed documentation were required at this stage on all cross-border transactions between associated enterprises, and by all enterprises engaging in such transactions. Therefore, it would be unreasonable to require the taxpayer to submit documents with the tax return specifically demonstrating the appropriateness of all transfer price determinations.

⁶⁶Ultimately the storage issue may depend on domestic law. Most countries may require taxpayers to keep documentation in paper format. However, depending on the development status of a country's electronic technology, some countries may require the taxpayer to store the material in a [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.

7.4.2.8. In practice, most countries *either* do not require the submission of transfer pricing related information at all *or* require only a minimum level of information at the tax return filing stage.

7.4.2.9. The PATA Documentation Package noted above indirectly encourages contemporaneous documentation by establishing a rule that a taxpayer that voluntarily uses the PATA Documentation Package must maintain contemporaneous documentation if they wish to avoid penalties. A number of countries have adopted provisions in their tax legislation similar to those of the PATA Package, providing that the tax administration cannot impose any penalty if a taxpayer complies with documentation obligations contemporaneously — adjustments can still be made and interest charged on those adjustments, of course.

7.4.2.10. The EU Code of Conduct itself does not require contemporaneous documentation but, in practice, files should be prepared contemporaneously if a relevant national law requires contemporaneous documentation.

7.4.3. Penalties

7.4.3.1. A country that requires its taxpayers to keep a certain level of documentation may operate a penalty system to ensure proper operation of its documentation system. Penalties in relation to transfer pricing regime can be generally divided into two groups based on the reason for imposing them: (i) for underpayment of tax that is due and (ii) for non-compliance with documentation requirements.

7.4.3.2. However, a number of countries also have incentive measures exempting penalties against underpayment of taxes in cases where obligations for proper documentation (frequently contemporaneous documentation) have been fulfilled by taxpayers even in cases where the amount of taxable income turns out to be increased as a result of a tax audit. The principle governing these incentive measures is often referred to as the “no-fault, no-penalty principle”.

7.4.3.3. In general, penalties can entail civil (or administrative) or criminal sanctions. Penalties imposed for failure to meet transfer pricing documentation requirements are usually monetary sanctions of a civil or administrative, rather than a criminal, nature. Tax audit or

discretionary application of transfer pricing methods⁶⁷ by tax authorities using a secret comparable or so-called “deemed income”,⁶⁸ are sometimes seen as a type of penalty for non-compliance with transfer pricing documentation rules. These cases are more closely scrutinized, and can equally be seen as resulting in greater risks of non-compliance in such cases.

7.4.3.4. It would be unfair to impose sizable penalties on taxpayers that exerted reasonable efforts in good faith to undertake a sound transfer pricing analysis to ascertain arm’s length pricing, even if they did not fully satisfy documentation requirements. In particular, it would be unproductive to impose penalties on taxpayers for failing to submit data to which they did not have access, or for failure to apply a transfer pricing method that would have required the use of data unavailable to the taxpayer. However, this does not mean that a transfer price cannot be adjusted retroactively, with interest accruing on that amount.

7.4.3.5. Some countries consider that a penalty imposed due to a lack of proper documentation can be dealt with through the Mutual Agreement Procedure between competent authorities under an applicable tax treaty, as it relates to the taxes to which the relevant treaty applies. Other countries consider that the issue of penalties, especially in relation to documentation, is distinct from the adjustments made and also from the issue of whether taxes have been imposed in accordance with the relevant tax treaty.

7.4.3.6. However, even where such a penalty is not covered by a tax treaty’s Mutual Agreement Procedure, the penalty should not be applied in a manner that would severely discourage or invalidate a taxpayers’ reasonable reliance on the benefits of the tax treaty. This includes the right to initiate the Mutual Agreement Procedure as provided in the relevant tax treaty.

7.4.3.7. For example, a country’s requirements concerning the payment of an outstanding penalty should not be more onerous to taxpayers in the context of the Mutual Agreement Procedure than they would be in the context of a domestic law review initiated by the taxpayer.

⁶⁷“Presumptive taxation” in Japan can be an example in this category.

⁶⁸Calculated using a formula stipulated in the tax law.

7.4.4. Special Considerations for Small and Medium-sized Enterprises

7.4.4.1. Comprehensive documentation requirements and subsequent penalties imposed on non-compliant taxpayers in a country 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 pricing documentation rules, based on which SME taxpayers or taxpayers without heavy involvement in international transactions can be exempted from the transfer pricing documentation requirements.⁶⁹

7.4.4.2. The following countries have been selected as samples to demonstrate special considerations for Transfer Pricing documentation in the case of SMEs:⁷⁰

France

France has issued guidance for SMEs, with the effect that the mandatory transfer pricing documentation requirements in the legislative proposal will only apply to large enterprises.^a Thus, SMEs should only undertake 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

^aA company with annual turnover or gross balance sheet assets of less than 400 Million Euro, which does not belong to an economic group, is exempted from documentation requirements.

⁶⁹See, for example, the analysis of existing transfer pricing simplification measures undertaken by the OECD available from <http://www.oecd.org/tax/transfer-pricing/50517144.pdf>

⁷⁰The following examples are largely quoted from a transfer pricing documentation survey conducted in 2009 by a company named Salans LLP (now part of another firm). The results of this survey are still available from <http://www.mondaq.com/x/85702/Transfer+Pricing/Salans+Vox+Tax+Transfer+Pricing+Documentation+Survey+Part+1> Further information on China is provided by Baker & McKenzie in their monthly publication called China Tax Monthly. Further information on Korea provided by the website of the National Tax Service in Korea available from <http://www.nts.go.kr/>

foreign entities. However, small companies are also encouraged to prepare contemporary transfer pricing documentation.

Germany

SMEs^b do not have a duty to issue Transfer Pricing documentation. However, they are obliged to provide further information and documents about the foreign business transactions when requested by tax authorities. In this case, less detailed transfer pricing documentation is required.

Netherlands

There are no specific rules applicable to SMEs; all enterprises are obliged to prepare and keep transfer pricing documentation. However, in practice, the transfer pricing documentation obligation is applied in a flexible 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 documentation requirements. However, the volume of the transactions does. The 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 intangible 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 burdens depending on the characteristics of the parties involved. Relevant factors include a turnover of 8 Million Euro 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

There are three kinds of enterprises that are exempt from the contemporaneous documentation obligation:

^bA company with turnover in goods of less than 5 Million Euro or turnover in services of less than 500,000 Euro falls in this category.

^cOne Euro was worth approximately 1.29 US\$ as of May 2013.

1. Entities with annual related party sales and purchases of less than 200 Million Yuan Renimbi^d and other related party transactions of less than 40 Million Yuan Renimbi;
2. Entities within the coverage period of an APA; or
3. Entities with less than 50 per cent foreign invested shares that only have transactions with domestic related parties.

Korea

The method used and the reason for adopting that particular method for an arm's length principle determination 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 Korean Won^e or less and 500 Million Korean Won or less, respectively. The above obligation is also exempt for the taxpayer whose inter-company transaction volume per an overseas related party is 1 Billion Korean Won or less for goods and 100 Million KRW or less for services.

India

Taxpayers with international related-party transactions valued at not more than 10 Million Indian Rupees^f are exempted from the obligation of contemporaneous transfer pricing documentation which must be prepared prior to the filing of Indian annual tax returns and retained for eight years.

^d6.2 Yuan Renmimbi were worth approximately 1 US\$ as of May 2013.

^e1,115 Korean Won were worth 1 US\$ as of May 2013.

^f55 Indian Rupees were worth approximately 1 US\$ as of May 2013.

7.4.4.3. In summary, some countries have particular legislative provisions that allow exemptions from the obligation for transfer pricing documentation, or for submission of documents to tax authorities at the time of filing tax returns. However, some countries allow similar exceptions by an administrative measure notwithstanding the lack of any specific legislation granting such exceptions. In some countries, exemptions or mitigation of transfer pricing documentation obligations are directly targeted at SMEs. However, a number of countries operate such exemption or mitigation regime mainly targeting taxpayers whose transaction volumes with overseas related parties are quite limited. Since many SMEs are not heavily involved in cross-border transactions with overseas related parties, they benefit from these exemptions in an indirect way.

7.4.5. Language to be Used for Transfer Pricing Documentation

7.4.5.1. The guidance provided by the EU Code of Conduct regarding language may be very useful for a country that wishes to establish its own transfer pricing documentation rule. As one of the basic principles to be applied to EU transfer pricing documentation, the Code states in Paragraph 6 of the Annex, that the country-specific documentation should be prepared in a language prescribed by the member states concerned, even if the MNE has opted to keep the country-specific documentation in the masterfile.

7.4.5.2. However, in Paragraph 23 of that same Annex prescribing the general application rules and requirements for member states, the Code states that it may not always be necessary for documents to be translated into a local language and that, in order to minimize costs and delays caused by translation, member states should accept documents in a foreign language as far as possible. Further, the Code recommends that, as far as the EU transfer pricing documentation is concerned, tax administrations should be prepared to accept the masterfile in a commonly understood language in the member states concerned, and that translations of the masterfile be made available only if strictly necessary and upon specific request.

7.4.5.3. According to a country survey,⁷¹ most countries require taxpayers to present transfer pricing documentation in their own language and require translation if the documentation was prepared in a different language. 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 documentation to be provided in English.

7.4.5.4. The recent 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.⁷²

⁷¹Please refer to footnote 70.

⁷²Further information available from http://www.us.kpmg.com/microsite/taxnewsflash/tp/2011/TNFTP11_02Egypt.html

7.4.6. Information to be Included in Transfer Pricing Documentation

7.4.6.1. In preparing transfer pricing documentation, MNEs must decide the type and scope of documentation and information that should be provided to tax authorities to meet various documentation requirements and avoid any tax adjustments and penalties, while at the same time minimizing added burdens and potential tax exposure in the event of a tax controversy.

7.4.6.2. The main objective of preparing and maintaining documentation is to place the taxpayer in a position where it can be readily demonstrated that reasonable efforts were undertaken to ensure that its transfer prices are consistent with the arm's length principle. As indicated in the previous sections, international documentation guidelines of the OECD, the PATA and the EU contain rather detailed documentation lists, respectively. Likewise, a number of countries have mandatory or illustrative lists of documentation requirements in their tax laws or regulations.

7.4.6.3. However, it is not possible to specify a comprehensive list of documentation requirements that would meet the needs of all taxpayers or tax administrations. This is because the documentation required depends on the specific facts and circumstances of each case, and the transfer pricing regime applicable in a country. Nevertheless, it would be useful to check common items or features that are included in transfer pricing documentation.

7.4.6.4. First of all, information as to the related parties that are involved in the controlled transactions at issue needs to be documented. Such information includes

- An outline of business with transaction parties;
- The structure of the organization;
- Ownership linkage within the MNE group;
- The amount of sales and operation outcome from the last few years preceding the transaction;
- The level of the taxpayer's transactions with foreign related parties, for example the amount of inventory sales, value of services rendered, rent for tangible assets, the use and

transfer of intangible property, and interest on loans, etc. Information relevant to the FAR Analysis would be important items for documentation.

7.4.6.5. The current business environment and forecasted changes or commercial and industry conditions affecting the taxpayer, such as market scale, competitive conditions, regulatory framework, technological progress and foreign exchange market, may also need to be documented.

7.4.6.6. An explanation of the selection, application, and consistency with the arm's length principle of the transfer pricing method used for the establishment of the transfer pricing is also needed. Information on factors influencing the setting of prices or the establishment of any pricing policies for the taxpayer and the whole MNE group would be also useful.

7.4.6.7. If the documentation is designed to allow the evaluation of comparables used in a transfer pricing study, it would not be sufficient merely to provide a list of "comparables". In cases where internal or third party comparables are used by a taxpayer to support its transfer pricing policy, supporting documentation should be provided explaining the process followed to arrive at a particular list of comparables and the arm's length range of those comparables. Comparables are dealt with in detail in Chapter 5 of this Manual.

7.4.6.8. The OECD Transfer Pricing Guidelines contain a description of a typical process used to identify comparable transactions and utilize the data so obtained through comparability analysis. Where a transfer pricing study relies on comparable information which has been obtained following such a process, it would be reasonable to expect each of the steps to be documented in order to make it possible for the tax administration conducting an audit to assess the quality of the analysis.

7.4.6.9. For example, if a taxpayer uses multiple year data on the ground that its transactions are affected by business cycles, it would be reasonable for the taxpayer to provide some documentation explaining why a business cycle is a factor to be considered, the type (e.g., business cycle, product cycle) and duration of the cycle and placement

of the controlled enterprise in the cycle. Based on this analysis, the qualitative and quantitative criteria used to select or reject comparables should be carefully documented.

7.4.6.10. Where a taxpayer concludes that no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the transaction, reasons for such conclusion should be duly explained together with supporting documentation.

7.4.6.11. Special circumstances would include details concerning any intentional set-off transactions that have an effect on determining the arm's length price. In such a case, documentation may be necessary to help describe the relevant facts, the qualitative connection between the transactions, and the quantification of the set-off arrangement. In this situation, contemporaneous documentation helps minimize the use of hindsight, and the possible suggestion of manipulation based on that hindsight.

7.4.6.12. Documentation of intra-group services is vitally important to allow tax authorities to satisfy themselves as to the legitimacy of intra-group service charges, including management fees. When documentation is prepared for intra-group services, it should be focused on whether intra-group services have in fact been provided and what the intra-group charge should be for such services for tax purposes. Once the relevant intra-group services have been identified, the documentation of such intra-group services performed by the service provider and the benefits received by the service recipient should be thoroughly prepared.

Cost contribution arrangements

7.4.6.13. A cost contribution arrangement (CCA) is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights. Documentation is crucial for the proper operation and tax treatment of a CCA because the form and value of each participant's contribution cannot be properly obtained without proper documentation. The prudent business management principles espoused in the OECD Guidelines would lead the participants to a

CCA to prepare or obtain materials regarding the nature of the subject activity, the terms of the arrangement, and its consistency with the arm's length principle.

7.4.6.14. Over the duration of the CCA's term, the following information could be particularly useful:

- Terms, participants, subject activity and conditions of initial arrangements and any change to the arrangement;
- The manner in which participants' proportionate shares of expected benefits are measured, and any projections used in this determination;
- The form and value of each participant's initial contributions, and a detailed description of how the value of initial and ongoing contributions is determined;
- Any provisions for balancing payments or for adjusting the terms of the arrangements to reflect changes in economic circumstances;
- A comparison between projections used to determine expected benefits from CCA activity with the actual results; and
- The annual expenditure incurred in conducting the CCA activity, the form and value of each participant's contributions made during the CCA's terms, and a detailed description of how the value of contributions is determined and how accounting principles are applied consistently to all participants.

Chapter 8

AUDITS AND RISK ASSESSMENT

8.1. Introduction to Audits and Risk Assessment

8.1.1. As discussed in Chapter 1, 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.

8.1.2. The outcome of an effective audit process has two aspects:

1. Increased future compliance (which indirectly contributes to future tax revenue and protection of the tax base); and
2. Increased current tax revenues (where cases are successfully audited).

8.1.3. 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 significant revenue adjustments that can be used for development of a 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 administration and the private sector often come under significant scrutiny, as the returns from the resources devoted to developing transfer pricing capability tend not to be quickly achieved and are not always easily identifiable.

8.1.4. 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.

8.1.5. Materiality,⁷³ 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.

8.1.6. 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.

8.1.7. 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 incorporated in an audit programme.

8.2. Organization and Staffing of Transfer Pricing Audits

8.2.1. Administrative Aspects

Administrative features

8.2.1.1. Tax administrations vary in terms of how their respective transfer pricing units are set up. The spectrum of transfer pricing work undertaken, policy regulations, geographic size, level and complexity of

⁷³Materiality 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 to that company, even if there is an error or discrepancy.

transfer pricing activity, quantum of the tax base, number of resources etc may impact on how the transfer pricing division is structured within the tax administration.

8.2.1.2. The following functions are nevertheless likely to exist in most countries with a fair degree of transfer pricing experience:

- Audit section: transfer pricing risk assessment⁷⁴ and audits;
- Specialist advisory function: provision of technical guidance on audits, dispute resolution (settlements) and negotiation of APAs etc;
- Competent authority: mutual agreement procedures; and
- APAs.

8.2.1.3. 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 example, some countries do not have an APA programme or an established transfer pricing Competent Authority section.

Administrative models

8.2.1.4. Generally, two types of structural models exist for organizing the transfer pricing capability; centralized and decentralized.

8.2.1.5 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.

8.2.1.6. An alternative approach within the decentralized model involves creating a specialist function at the centre of the tax administration 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.

⁷⁴In some instances the risk assessment capability may be undertaken by a separate section distinct from the audit section.

8.2.1.7. 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 developing 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 4, Paragraph 4.5. and following for further analysis of the centralized and decentralized models.

8.2.2. Staffing and Resourcing

8.2.2.1. 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 nevertheless critical to the efficient, timely and successful conclusion and even resolution of an audit.

8.2.2.2. The challenge most developing countries face is the ability to employ, develop and retain these resources. In this regard, developing countries need to be innovative and strategic. Implementation of targeted recruitment and structured training programmes will assist developing countries in attracting, developing and retaining transfer pricing skills. Training and development including challenge and variety in work scope within the public sector is also often an attractive aspect of government work and tax administrations in developing countries need to leverage off this to attract and retain transfer pricing resources. See further Chapter 4, Paragraph 4.6.1. and following.

8.2.2.3. Most tax administrations employ a variety of skills within transfer pricing units. These include economists, lawyers, accountants, industry experts and generalists. Over time those become transfer 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.

8.2.2.4. It is neither practical nor good governance for a transfer pricing audit to be conducted by a single auditor (be it a specialist 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 countries it is customary for every transfer pricing audit team to include an economist. In other countries, the presence of an experienced transfer pricing specialist is essential especially if the audit is done in partnership 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.

8.2.2.5. 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.

8.2.2.6. 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.

8.2.2.7. Developing countries may want to explore the option of staff exchange with developed countries as a way of building capability and capacity. This could be a useful mechanism for developing countries to expand their transfer pricing capabilities as seconded staff from other countries could be utilized to train and develop transfer pricing resources and provide input into audits. Moreover, staff returning from abroad, could be used to train colleagues.

8.2.2.8. Various international organizations such as the 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. The United

Nations also has plans for undertaking a training and capacity building programme in the future. 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. The next edition of this Manual is expected to include a list of available training resources and advice on accessing them.

8.3. Selection of Taxpayers for Transfer Pricing Examination: Risk Assessment

8.3.1. Overview

8.3.1.1. Effective risk identification and assessment are important steps toward ensuring that the most appropriate cases are selected for audit. Given the resource constraints it is important for any tax administration that high risk transfer pricing cases do not “slip through the tax net”. However, even the most robust risk identification and assessment tools and processes may not always guarantee success in audit. The reason for this is that the level of detail available at the risk assessment 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, allocation keys selected and so forth.

8.3.1.2. There are several ways in which a tax administration may conduct its risk identification and assessment, and the approach taken is largely dependent upon the type of information and data that is available and accessible. For example, exchange control authorities in some countries may work hand in hand with the tax administration 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 information is submitted. This is very useful in risk identification and assessment, as the availability of all such relevant information can enhance the quality of the risk identification and assessment process.

8.3.1.3. It is important to draw a distinction here between the information related to filing a tax return and that contained in transfer pricing documentation. This may vary from country to country but in essence is as follows:

- Filing information typically relates to questions on a tax return. This may entail a tick the box (i.e. yes or no) 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 questions about a transfer pricing policy document, legal contracts, invoices, valuations etc. Chapter 7 of this Manual addresses documentation requirements in more detail.

8.3.1.4. 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 increasingly complex in nature. See Chapter 7 for a more detailed in-depth analysis of transfer pricing documentation issues.

8.3.1.5. 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.

8.3.2. Categories of Risk

8.3.2.1. Transfer pricing risks arise through intra-group transactions 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.

8.3.2.2. 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 determining whether a case is worth pursuing (now or later) and whether or not the requisite resources and expertise are available.

8.3.2.3. The following describes some of the more complex categories of risk that are not always readily identifiable. It is by no means exhaustive and it is acknowledged that additional classes and categories 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 functional classification, the use of incorrect methods, allocation keys, etc;
- Category 4: Thin capitalization; and
- Category 5: Unintentional profit shifting.

8.3.2.4. 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 potential 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

8.3.2.5. 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.

8.3.2.6. It is however difficult to detect these structures through general risk identification and assessment process as such structures are often not disclosed. The likelihood of detection is therefore often low. In such instances a tax administration’s awareness of possible 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

8.3.2.7. This category is different from Category 1 by 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.

8.3.2.8. In this situation the jurisdiction where the MNE is headquartered 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/entrepreneurial” entity remaining or created as a result of the restructuring.

8.3.2.9. 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

8.3.2.10. MNEs may intentionally shift profits through the misclassification of entities, the application of incorrect pricing policies or unsuitable allocation keys. For example an entity may, during a period of economic upturn, be classified as a limited risk distributor and be rewarded with a fixed (but relatively low) 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 turn-over as opposed to the actual services performed thereby extracting profits through excessive service charges.

8.3.2.11. 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.

8.3.2.12. 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

8.3.2.13. This category includes both intentional and unintentional profit shifting by MNEs through debt. In most countries, thin capitalization is regulated through safe harbours set at predetermined levels of debt to equity. Where this is the case, the likelihood for risk profilers/assessors of spotting such abuse is high, as these calculations can be easily performed or even automated to flag thinly capitalized entities. Even in cases where countries do not have safe harbours, they can set parameters or thresholds for risk assessment purposes.

8.3.2.14. 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

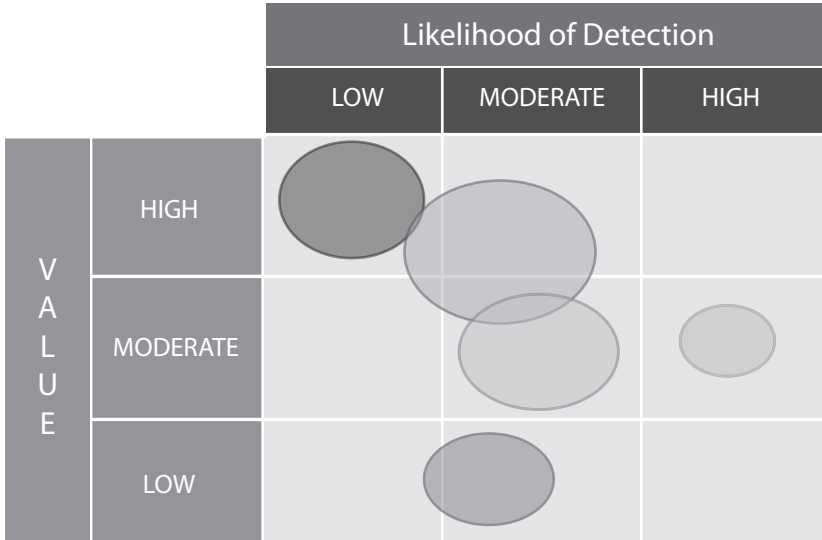
8.3.2.15. This category results from cases where mis-pricing by taxpayers occurs but was unintended. A revenue authority may disagree with the pricing policies applied whether it be the functional classification, methods applied, etc.

8.3.2.16. Where this occurs it is likely that the values could be material (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.

8.3.2.17. The descriptions of the risk categories explained above are summarized on a simple matrix in Figure 8.1. The likelihood of detection 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.

8.3.2.18. 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 transaction”. An “inbound MNE” is an MNE which is headquartered elsewhere 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 8.1: Likelihood of Detection



8.3.2.19. An “inbound transaction” is a transaction where the goods or services are flowing into the country where the risk assessment is being conducted; and vice versa for an “outbound transaction”. It is worth noting that an outbound MNE may have inbound transactions. When evaluating the outbound MNE, certain flags would be triggered whereas the evaluation of the inbound transactions undertaken by the outbound MNE would trigger other risk issues. These are summarized in the table below:

Table 8.1: 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	<ul style="list-style-type: none"> Offshore procurement/sourcing companies to keep profits offshore General mis-pricing (intentional/unintentional) 	<ul style="list-style-type: none"> Offshore marketing companies to keep profits offshore General mis-pricing (intentional/unintentional)
Services	<ul style="list-style-type: none"> Excessive fees relative to benefit provided Charging when no service received Duplication/shareholder services 	<ul style="list-style-type: none"> No charge at all Excessively low fees relative to benefit provided

TYPE	INBOUND TRANSACTIONS/MNEs	OUTBOUND TRANSACTIONS/MNEs
Intangibles/ Intellectual property	<ul style="list-style-type: none"> • Excessive charges • Duplicating charges through royalties over and above inflated prices 	<ul style="list-style-type: none"> • Not charging for intangibles developed locally • Externalizing intellectual property without reward
Structures	<ul style="list-style-type: none"> • Restructuring • New structures 	<ul style="list-style-type: none"> • Restructuring • New structure • To avoid/minimize imputation through controlled foreign corporation • Use of offshore branches in low-tax jurisdictions with double taxation treaties

8.3.3. Types of Approach

8.3.3.1. There are various approaches that one could take in order to identify companies/groups with transfer pricing risks. These include:

- The transactional approach;
- The jurisdictional approach; and
- The risk-based approach.

Transactional approach

8.3.3.2. 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 access to information restrictions some jurisdictions may face greater difficulty in auditing service transactions whereas other jurisdictions may be able to audit these transactions with relative ease.

8.3.3.3. Alternatively, the focus could be on higher risk transactions with a higher possible revenue yield, such as business restructurings, for example. Finally, examination of a combination of more complex and simpler transactions can be adopted in order to ensure a more consistent flow of work and revenue.

Jurisdictional approach

8.3.3.4. A revenue authority may adopt an approach under which transactions entered into with entities in previously identified tax jurisdictions are prioritized for audit. A crucial element of this approach is the inclusion of both direct and indirect transactions entered into with such jurisdictions, e.g. schemes or structures ultimately benefitting or involving entities in these identified jurisdictions. This will require the transfer pricing unit to identify those jurisdictions it considers to be of higher risk, within the context of domestic tax rates, domestic trade flows and domestic economic policies.

8.3.3.5. It may be that transactions involving related parties in jurisdictions with higher tax rates are flagged for prioritization by tax authorities 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 jurisdictions) at the cost of the jurisdiction where transfer pricing is not as aggressively pursued. In adopting this approach, care should be taken not to act contrary to international non-discrimination rules such as may be found in applicable tax treaties and/or domestic law.

Risk-based approach

8.3.3.6. 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.

8.3.3.7. Other factors of interest might for instance include:

- The tax compliance status of the local entity or the multinational group to which the entity belongs, i.e. how compliant is the company/group generally or specifically as to transfer pricing in that country or elsewhere in the world. Where groups/entities have been successfully investigated by other revenue authorities this could provide an indication that the group presents a higher risk for transfer pricing purposes;

- A group that has recently undergone a business restructuring, particularly where the local entity has been “stripped” of certain risks and/or functions as part of the restructuring;
- Companies with excessive and/or continued accounting or tax losses relative to a profitable group outside the country where the risk is being assessed.

8.3.4. Sources of Information for Risk Assessment

8.3.4.1. Tax authorities should work as far as possible with the information provided by the taxpayer. The tax return should ultimately aim to obligate taxpayers to include the information that would be most useful for the tax authority to utilize for effective risk assessment. The use of quantitative rather than qualitative data will assist in the automation of risk assessment tools. Examples of useful information on transactions include the value of the following transactions 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.

8.3.4.2. 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 developing countries may often have to be more reliant than their colleagues in developed countries on information provided by taxpayers.

8.3.4.3. Published judgements of cases heard in other countries may contain useful intelligence regarding a group’s activities, transactions and pricing policies. These could also provide useful guidance on structures/schemes implemented in certain industries. The analyses of

such decisions provided by law and accountancy firms to their clients, are often freely available, and can also be helpful in identifying similar issues in another jurisdiction. Access to transfer pricing information databases summarizing and often including the full judgements, such as those by commercial publisher 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.

8.3.4.4. Particular attention should be paid to any notes to the financial statements on related party transactions and loans/financial assistance.

8.3.4.5. Customs data, can, in some cases, be relevant to obtaining information on intra-group transactions. It is sometimes the case that the import price may be an indicator of the true transfer price.

8.3.5. Risk Factors

8.3.5.1. Certain risk factors or “flags” can point to the need for further examination. They should not be treated as decisive in determining that non-arm's length pricing has occurred, of course — at most they point to a higher than normal likelihood of such mis-pricing. Chapter 4 addresses some additional indicators of risk, but some commonly agreed risk indicators include:

- Consistent and continued losses;
- Transactions with related parties in countries with lower effective/marginal tax rates, especially “secrecy jurisdictions” from which tax information is not likely to be shared;
- Local low profit or loss making companies having material cross-border transactions with related parties offshore, where the offshore part of the group is relatively much more profitable;
- The existence of centralized supply chain companies in favourable tax jurisdictions i.e. centralized sourcing or marketing companies located in jurisdictions with low-tax or no-tax regimes and which are not located in the same country/region as the group's main customers and/or suppliers;

- Material commercial relationships with related parties in jurisdictions with aggressive/strict transfer pricing rules — the corporate group may be more likely to set transfer prices in favour of the more aggressive jurisdiction at the cost of the less aggressive jurisdiction, due to the higher likelihood of intense scrutiny in the first jurisdiction;
- The same applies in the case of material commercial relationships with companies located in the “home” jurisdiction of the MNE or the location where the holding company is listed;
- Similar considerations apply where there are material commercial relationships with companies in jurisdictions that employ safe harbours or similar rules that do not always align to the arm’s length principle.

8.3.6. The Risk Assessment Process

8.3.6.1. As stated, the risk identification and assessment process may vary from one tax administration to another depending on the approach taken, the resource capability, 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 identification and assessment process will depend on what a tax administration has at its disposal in terms of information, capability and systems or technology. It can however be said that the more refined and sophisticated the risk identification and assessment process, the easier it will be to ensure that material high risk transactions are identified and audited in a timely manner.

8.3.6.2. The basic steps of the risk assessment process can be described as follows:

- Initial review and identification of the possible risks;
- High-level quantification of the possible risks;
- Gathering of other intelligence;
- Decision as to whether to proceed;
- More in-depth risk review including high-level review of documentation and functional analysis to confirm initial findings;

- More detailed quantification of possible risks;
- Initial interactions with taxpayer; and
- Decision as to whether to proceed to audit by way of specialist reviews or committee based/panel reviews.

8.3.7. Risk Assessment Tools

8.3.7.1. Some of the more common risk identification and assessment 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 example, 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.

8.3.7.2. Where specialist transfer pricing capability and resources are limited, generalist auditors may be used to assist with risk identification and assessment. In such cases these basic tools ideally do not require generalist auditors to apply their discretion or have specific transfer pricing/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.

8.3.7.3. Basic quantitative risk assessment tools are particularly effective in the identification of thin capitalization risks as this usually involves a quantitative test of the financial data and is in most cases, depending on the local legislation, a matter of objective fact rather than more subjective opinion. Automated risk assessment tools that can be used to run through large sets of available data can be used very effectively in this area.

8.3.8. Risk Assessment Findings

8.3.8.1. It is important that the outcomes of a risk identification and assessment process be documented and signed off for governance

and control purposes and preferably saved in a central repository, i.e. a database of cases assessed whether or not proceeding (including all workings), with an effective back-up strategy.

8.3.8.2. The tax administration should design templates containing key information relevant to their domestic requirements. Ideally these should include:

- Statutory filing requirements (e.g. tax number etc);
- The nature of the transactions and risks identified;
- The 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.

8.4. Planning for a Transfer Pricing Examination

8.4.1. Formation of the Examination Team

8.4.1.1. Where the transfer pricing unit of the tax administration 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 primarily 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 international examiners as well as economists in analyzing transfer pricing issues.

8.4.1.2. The above-mentioned persons may not always be present in one examination team and may be provided as needed depending 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.

8.4.1.3. The international examiner, the transfer pricing economist and the lawyer are likely to be present in most cases. The international examiners are indispensable in the light of the international nature of transfer pricing. They receive special training in international issues and, in many cases, are more senior and experienced than domestic examiners. The team leader often consults the international examiner.

8.4.1.4. 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 arguments when in discussion with the taxpayer; and
- Preparing or assisting the preparation of a report addressing the conclusions of the team.

8.4.1.5. The lawyer will often be involved at an early stage in reviewing important substantive or procedural decisions. Additionally, the lawyer will be consulted concerning the procedures to be used for information gathering, may be involved in drafting questions posed in information requests and may also participate in interviews of company personnel. The lawyer is expected to contribute to more carefully

crafted inquiries for information and to resolve administrative and substantive issues. Also, the participation of the lawyer in the audit process may expedite and make more effective the preparation of the case for possible litigation.

8.4.2. Supervision of Examination

8.4.2.1. A key issue for a tax administration is how to ensure transfer pricing audit approaches are uniform over the whole country. This is especially a pressing problem for a country which has a vast geographical area to cover. An illustration of an effort to solve the “uniformity” problem can be seen from the case of Japan.

8.4.2.2. 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 explanation of the facts of the case and the reasons for the adjustment; transfer pricing divisions were also encouraged to consult the Director (International Examination) during the course of the examination.

8.4.2.3. This was possible at the early stages of transfer pricing enforcement because the number of transfer pricing cases was small. As the number of transfer pricing cases increased, however, it became impossible for the Director (International Examination) to control all these cases. Therefore, gradually, the supervisory power has been delegated to the Senior Examiner (International Taxation) at each regional taxation bureau. The Director (International Examination) now supervises only the larger transfer pricing audit cases. It is now possible to supervise transfer pricing audits at the level of the regional taxation bureaus as the number of tax officials who share common knowledge and expertise in transfer pricing has increased considerably.

8.4.3. Issues for Examination/Examination Plan

8.4.3.1. It is necessary to decide what issues will be investigated in a transfer pricing examination.⁷⁵ This involves the establishment of a transfer pricing examination plan; see Paragraph 8.6.1 of Chapter 8 for further discussion of the examination plan.

8.4.4. Audit Timetable

8.4.4.1. A transfer pricing audit usually takes longer than an ordinary tax audit because the scope of the factual matters to be investigated is much broader 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 examinations rarely proceed in accordance with the timetables set forth in the examination plan. The main reason is that the progress of an examination depends on whether the information requirements set forth in the examination plan are satisfied. Unfortunately, the required information is not always obtained on time. It may be necessary to check the progress of the audit periodically to reconsider the audit timetable and the extent of information needed by the audit team.

8.4.5. Information Already in Hand

8.4.5.1. Tax authorities are already in possession of certain necessary 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.

⁷⁵Transfer pricing audits can also be described as “examination” programmes, though it is also possible to use the term “examination” in a wider sense, e.g. to cover compliance checks of transfer pricing processes without doing a full scale audit.

8.4.6. Information to be Collected

8.4.6.1. 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.

8.4.6.2. It should be noted that the taxpayer's cooperation in providing 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.

8.4.6.3. The principal means for the audit team to collect the necessary 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 pricing audit. The time given for responding is usually a few weeks, unless the taxpayer is expected to take a longer time to obtain and/or prepare the required information. Tax authorities can also utilize the exchange of information provision in an applicable tax treaty.

8.4.6.4. It should be noted that a common problem is the challenge in enforcing an information request which seeks a document or information not held by the taxpayer under investigation, but is 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 documents and accounting books held by its related party outside Japan. The Japanese tax authorities have the statutory authority to impose presumptive taxation if the requested data is not submitted by the taxpayer.

8.4.6.5. The United States has more forceful means of obtaining documents located outside the country. Firstly, the Internal Revenue Service (IRS) may issue a Formal Document Request (FDR) to a taxpayer to request foreign-based documentation under Section 982 of the Internal Revenue Code (IRC) after normal request procedures have failed. If the taxpayer fails to substantially comply with the FDR within 90 days it may be precluded from introducing any foreign-based documentation covered by the FDR as evidence at a trial where the documentation is relevant. Secondly, the IRS can request a taxpayer to obtain authority from a foreign related entity to act as an agent of that entity for the purposes of a summons under Section 6038A(e) of the IRC. Where the taxpayer fails to obtain the authorization, the IRS may determine the amount at issue based solely on the information available to it. Thirdly, the Third-Party Summons procedure is available to the IRS under Section 7602 of the IRC. The IRS must provide “reasonable notice” to the taxpayer before contacting any other party regarding the taxpayer’s tax liability and must provide to the taxpayer a list of the persons contacted by the IRS periodically or upon the taxpayer’s request.

8.4.7. Statute of Limitations as Provided for in the Domestic Law

8.4.7.1. The statute of limitations 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 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 for both. On the other hand, Japan applies a statute of limitations of six years to transfer pricing cases while the statute of limitations on ordinary corporate income tax liabilities is five years. Canada’s statute of limitations is six years for transfer pricing cases and three years for ordinary tax cases.

8.4.7.2. 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 limitations is fixed and the benefit cannot be waived by a taxpayer.

8.4.8. Approvals and Sign-off

8.4.8.1. 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.

8.5. Preliminary Examination

8.5.1. Desk Audit

8.5.1.1. As noted above, the tax authorities have certain transfer 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.

8.5.1.2. Comparing the taxpayer's financial ratios to applicable standard industry ratios is useful if standard industry ratios can be found. Substantial deviations from standard industry ratios may indicate a transfer pricing problem. The findings from the desk audit should be analyzed to determine what further action, if any, is needed.

8.5.2. Understanding the Taxpayers' Business

8.5.2.1. 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 (domestic 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.

8.5.2.2. The following may be useful sources for gaining an understanding of the taxpayer's business operations:

- Transfer pricing documentation;
- Annual reports;
- Securities reports;
- 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 shareholders' 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.

8.5.2.3. The following questions are among those which may be asked in order to understand the taxpayer's operations:

8.5.2.4. 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 trademarks and other marketing intangibles?
- Which members of the controlled group advertise?
- Which members of the controlled group created the sales tools?
- Which members of the controlled group created and maintained the list of customers?

8.5.2.5. If the taxpayer is engaged in the *manufacturing* of products:

- Are affiliates distributing or selling the same or similar products to those the taxpayer manufactures?
- Is the taxpayer using the same or similar manufacturing intangibles to those its affiliates are using?
- What patents and/or know-how are involved in the 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 development?
- How are the results of research and development disseminated among members of the controlled group?

8.5.2.6. 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.

8.5.3. Understanding the Industry in which the Taxpayer Operates

8.5.3.1. The following procedures may be used in order to understand 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.

8.5.4. Approval

8.5.4.1. 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.

8.5.4.2. The approval process will need to be coordinated with the organizational model of the transfer pricing administration. See further Chapter 4, Paragraph 4.5. and following.

8.6. Audit Procedure

8.6.1. Audit Approach

8.6.1.1. The examiners need to establish the transfer pricing examination 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;
- 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.

8.6.2. Notification to Taxpayer

8.6.2.1. A transfer pricing audit usually brings the examiners into contact with the taxpayer by phone for scheduling an initial appointment. If such contact cannot be made the examiners will send a letter notifying that they will audit the taxpayer. This is the time when the examiners send the initial information request to the taxpayer. If contemporaneous documentation is required this is also the time to trigger the period of submission of the contemporaneous documents.

8.6.2.2. 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 statute of limitations is six years the taxable years to be covered may be five or six years.

8.6.2.3. The examiners will usually suggest a meeting with the taxpayer, where the examiners may discuss the schedule of the transfer pricing audit and certain ground rules. If the taxpayer has submitted certain requested documents the examiners may also discuss the contents of such documents.

8.6.3 Gathering of Information

8.6.3.1. Certain information needed for the transfer pricing audit is already in the hand 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 transfer 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;
- **Information returns:** Information returns may be required for transfer pricing purposes.

Schedule 17(4): Particulars concerning Foreign Related Persons

		Business Year or Consolidated Year		Corporation's Name		
Name, etc of Foreign Related Persons	Name					
	Head or Main Office					
	Principal Business					
	Number of Employees					
	Capital or Equity Amount					
	Classification of Special Relationship		Item #_	Item #_	Item #_	
	Percentage of Share Holding	Hold		%	%	%
		Held		%	%	%
		Shares of Foreign Related Person Held by Same Person		%	%	%
	Operating Revenues, etc in the Most Recent Business Year	Business Year		From:	From:	From:
		To:	To:	To:		
Operating Revenues or Sales						
Operating Expenses		Cost of Goods Sold				
		Selling, General and Administrative Expenses				
Operating Profit						
Net Profit before Tax						
Earned Surplus						

Status etc.of Transactions with Foreign Related Persons	Price of Inventory Asset Sold or Purchased	Receipt	mil.yen	mil.yen	mil.yen
		Payment	mil.yen	mil.yen	mil.yen
		Calculation Method	mil.yen	mil.yen	mil.yen
	Price of Services Provided	Receipt	mil.yen	mil.yen	mil.yen
		Payment	mil.yen	mil.yen	mil.yen
		Calculation Method	mil.yen	mil.yen	mil.yen
	Rentals of Tangible Fixed Assets	Receipt	mil.yen	mil.yen	mil.yen
		Payment	mil.yen	mil.yen	mil.yen
		Calculation Method	mil.yen	mil.yen	mil.yen
	Royalties of Intangible Fixed Assets	Receipt	mil.yen	mil.yen	mil.yen
		Payment	mil.yen	mil.yen	mil.yen
		Calculation Method	mil.yen	mil.yen	mil.yen
	Interest of Loan(s) or Borrowing(s)	Receipt	mil.yen	mil.yen	mil.yen
		Payment	mil.yen	mil.yen	mil.yen
		Calculation Method	mil.yen	mil.yen	mil.yen
Existence of APA			Yes No	Yes No	Yes No

8.6.3.2. 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.

8.6.3.3. It is useful to interview the personnel of the taxpayer engaged in marketing and sales and those in the accounting and financial departments. See Chapter 8, Paragraph 8.6.10. for more details.

8.6.3.4. 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 Chapter 8, Paragraph 8.6.11. for more details.

8.6.3.5. 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 taxpayer’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.

8.6.4. Sources of Information

8.6.4.1. The principal information source is the taxpayer. The taxpayer's books, records and other written documents, and its directors and employees are the principal sources of information.

8.6.4.2. A former employee or director of the taxpayer may also be a source, if necessary. In this event the former employee or director may be bound by a contract with the taxpayer not to disclose any secret information. This often causes a difficult legal question as to whether the former employee is obliged to disclose the requested information to the tax authorities. This question must be resolved in light of the domestic law of the country concerned.

8.6.4.3. A third party is also a possible source of information. For example, Japanese tax law authorizes the Japanese tax authorities to request information from a corporation engaging in a business activity which is of the same type or examine the accounting books and documents of that person or corporation.⁷⁶ Tax returns of a third party in the same business will also be useful sources of information. When a third party's information is used the tax authorities are confronted with a statutory obligation of confidentiality when dealing with the taxpayer. This is often discussed in the context of secret comparables.

8.6.5. Language

8.6.5.1. The documents a taxpayer possesses with respect to its transactions with a foreign related party are often written in a foreign language that tax auditors may not understand. Tax law in most countries is generally silent as to which side should translate a foreign language in the documents necessary for transfer pricing audit. If the documents are voluminous the cost of translation is substantial.

8.6.5.2. When the relevant documents are written in a foreign language 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.

⁷⁶Japanese Special Taxation Measures Law Art. 66-4, Paragraph 8.

8.6.5.3. If a document necessary for a transfer pricing audit is written in a foreign language and cannot be understood by the examiners, it will generally be the party with the burden of proof that will suffer a disadvantage.

8.6.5.4. The English language may have a unique position as a foreign language in this context. In most non-English speaking countries tax examiners in charge of transfer pricing taxation are trained to understand English and may be able to read documents in English.

8.6.6. Types of Information to be Gathered

8.6.6.1. General information required for a transfer pricing audit includes:

- A corporate profile;
- The organization of the taxpayer and the related parties;
- The transactions or business flows;
- A list of manufacturing and/or sales facilities;
- A list of directors and employees; and
- A diagram of group affiliates with capital relationships.

8.6.6.2. The taxpayer's financial statements provide basic financial information. However, the transfer pricing audit is often focused on the sales or purchases of particular products, the provision of particular services or the licensing of particular technology. It then becomes necessary to segment revenues, expenses, gross profit and/or operating profit. A segmentation of the profit and loss statement is thus often conducted, focusing on transactions under review by the tax auditors. The preparation of segmented profit and loss statements will require additional work by the taxpayer, who knows the details of the profit and loss statements. The accurate review and assessment of the financial results would be impossible without segmented profit and loss statements.

8.6.6.3. Third party information required is basically comparable data. The sources of the third party information may vary depending on the possibility of finding appropriate comparables. See further Chapter 5 on Comparability Analysis.

8.6.7. Points for Examination at the Initial Stage

8.6.7.1. In order to correctly ascertain whether any issue exists in relation to the transactions in the examination process, each case should be examined carefully, bearing in mind the circumstances of each transaction. In conducting a transfer pricing audit the following points should be taken into consideration along with the functions performed, risks assumed and assets used 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 compared with those of other transactions conducted by the taxpayer with unrelated persons in a similar market and which are similar in quantity, market level, and other respects;
- Whether the gross and operating profit margins arising from related transactions of the taxpayer are excessively low compared with those of other unrelated persons engaged in the same category of business that are similar in quantity, market level, and other respects;
- Whether the taxpayer's gross and operating profit margins arising from related transactions are relatively low compared with those of the related persons arising from the same transactions.

8.6.7.2. Prior to the calculation of arm's length prices, examinations should be conducted from different viewpoints in order to determine whether there are any issues regarding transfer pricing and to ensure that the examinations are conducted effectively. The following methods could be used:

- Verification of whether or not the gross and operating profit margins of related transactions under the examination are within the range of the profit margins of uncontrolled transactions in the same business category and substantially similar to the related transactions in terms of quantity, market level and other respects;
- Use of the average value of the consideration or profit margins for related transactions or transactions deemed com-

parable 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.

8.6.7.3. Once the transfer pricing audit starts, various aspects of arm's length pricing will be involved and will consume a considerable amount of time. After the above examinations, it may be useful to pause to reflect upon the audit in general. This will occur before starting the calculation of an arm's length value, which will consume the biggest part of the transfer pricing audit resources. The auditor should review whether it is likely that continuing the transfer pricing audit would produce a fruitful result from the viewpoint of efficiency.

8.6.8. Contemporaneous Documentation

8.6.8.1. Contemporaneous documentation is explained in detail in Chapter 7. 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.

8.6.8.2. The taxpayer is usually required to provide the examiners with the contemporaneous documentation within a specified number of days after a request from the tax authorities. Such documentation should demonstrate that the transfer pricing method and its application provide the most reliable measure of an arm's length price. This represents the first opportunity for the taxpayer to persuade the examiners that the transfer pricing is appropriate. Incomplete or inaccurate contemporaneous documentation may provide the examiners with a "road map" for their transfer pricing audit.

8.6.9. Information Request/Supplemental Information

8.6.9.1. The following is a sample list of information documents required from a corporation engaged in the distribution of products

on the assumption that the taxable period under audit is five years. The requested information should be the most up to date unless otherwise required.

- Corporate profile 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, staffing, prices, contractual terms with customers (consignment/cash sales etc) including data on the latest three years for sales, revenue and staffing;
- List of directors;
- Equity 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 the global consolidated basis profit and loss statement and ratio of taxpayer's sales towards group global sales for last five years;
- Segmented profit and loss statements from the related transactions of the related party (if the taxpayer is the purchaser) or the taxpayer (if the taxpayer is the seller) for 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, purchase price and retail prices, personnel expenses, advertising expenses and sales promotion expenses) for the last five years.

8.6.9.2. As the transfer pricing examination progresses many more questions will arise in the minds of the examiners, and accordingly many supplemental information requests need to be issued by the examination team. This part of the examination process tends to be necessarily lengthy.

8.6.10. Request for Interviews

8.6.10.1. It is common in a transfer pricing audit for the examination team to request interviews with key company personnel involved in transactions with related parties. The interviews assist the examination team's functional analysis for purposes of determining the functions performed by the taxpayer and related parties and 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.

8.6.10.2. The examination team will choose the personnel to interview by requesting organization charts. The personnel to be interviewed are decided by the examination team based on mutual discussion of the functions of the personnel in the organization charts.

8.6.10.3. The interviewees should be made familiar with the process and should understand the procedures, purpose and importance of the interview.

8.6.10.4. 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.

8.6.10.5. If the person to be interviewed is not a native speaker of the language of the interview it is advisable to use an interpreter even if he/she can speak the language fairly well. The use of an interpreter will avoid the possibility of misunderstanding questions and allow the interviewee time to formulate reasoned responses.

8.6.10.6. If an interview is recorded both parties should keep a copy of the record. It may be useful to have a transcription of the interview record 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.

8.6.11. Request to Visit Facilities

8.6.11.1. 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 particular locations and respond to questions. This guide should consider the exercise as being similar to an interview or an opportunity to present factual portions of the taxpayer's case as this explanation may affect the taxpayer's position in describing objects or operations on the tour. Ensuring integrity of such contacts with taxpayers is as important here as in other cases of dealing with taxpayers.

8.6.12. Secret Comparables

8.6.12.1. There is an issue concerning secret comparables which often surfaces in connection with transfer pricing audits. Confidential information from other taxpayers may be reviewed for general information or suggestions for further investigation. However, using such information to establish comparables will be a problem. Secret comparables are discussed in detail at Chapter 5, Paragraph 5.4.8.

8.6.12.2. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration provides 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.”

8.6.13. Attorney-Client Privilege and Work Product Doctrine

8.6.13.1. The attorney-client privilege and the work product doctrine are well developed in the United States and other countries, although such privilege and doctrine may not be so developed in other countries. The attorney-client privilege protects communications 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.

8.6.13.2. 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 transfer pricing examination, the due consideration of the attorney-client privilege and the work product doctrine would be important, where they are applicable.

8.6.14. Comparison Chart

8.6.14.1. 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 8.2: 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		

8.7. Narrowing of Issues: Development of Tax Authorities' Position

8.7.1. Refining Understanding of the Taxpayer's Business

8.7.1.1. 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 information requests and other information gathering activities. This will lead to a refined understanding of the taxpayer's business and such information will affect the choice of comparable transactions or companies.

8.7.2. Refining Understanding of the Taxpayer's Industry

8.7.2.1. Similar efforts will be needed in refining the understanding 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.

8.7.3 Refining Functions and Risk Analysis

8.7.3.1. The examination team will need to understand the functions and risks of the taxpayer and its affiliates before attempting to determine whether particular transactions or companies are comparable to the taxpayer. The examiners will need to identify the functions 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 transactions through the taxpayer. They determine who performed significant functions, whether any valuable intangibles were involved and reasons for the transactional structure.

8.7.3.2. The examiners will need to determine the effect of intangible 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, pricing, and inventory activities), foreign exchange risks (such as fluctuations in foreign currency exchange rates and interest rates), credit and

collection risks, product liability risks and general business risks and (ii) whether they receive an appropriate benefit for their contributions.

8.7.3.3. The examiners analyse 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 5 and 6.

8.7.4. Choice of Transfer Pricing Method

8.7.4.1. After refining the functional and risk analysis, the examination team will choose the transfer pricing method in the light of that analysis. See further Chapter 6 on the selection of an appropriate method.

8.7.5. Economist's Report or Examiners' Interim Opinion

8.7.5.1. Toward the end of the examination procedure, the examination 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 resolution until the end of the examination process.

8.7.5.2. The taxpayer has significant flexibility at this stage. It may refuse and disagree with the report or opinion, accept or suggest modifications. of.

8.7.6. Draft Proposed Adjustments

8.7.6.1. 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.

8.7.6.2. In some countries, the proposed adjustments may be combined with the examiners' interim report described above, depending on the circumstances.

8.7.6.3. This will be the last chance for the taxpayer to determine whether or not to reach a settlement with the examination team.

8.7.7. Formal Notification to Taxpayer of Proposed Adjustment

8.7.7.1. Unless the taxpayer and the examination team can reach agreement, the formal notification of the proposed adjustment will be issued.

8.7.7.2. 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 opportunity to accept the notification within a stipulated time (for instance, 30 days) and/or notify any set-offs. In other countries this formal notification procedure does not exist.

8.7.8. Issuance of Adjustment/Correction

8.7.8.1. 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.

8.7.9. Settlement Opportunities

8.7.9.1. 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.

8.7.9.2. If a settlement cannot be achieved with the examination 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.

8.7.9.3. 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 9 of this Manual.

8.8. Case Closure

8.8.1. The case closure needs to be properly documented, as every decision taken can potentially be subject to litigation. The table below provides a clear documentation process to ensure the information needed is recorded and to guarantee that the required process has been followed. The Audit Report is also captured in the table with all the required details.

8.9. Relationship between Transfer Pricing Audits and Advance Pricing Agreements

8.9.1. 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 transfer 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.

8.9.2. 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 business) 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 pricing aspects will not be conducted for the years to be covered by the APA application (including the roll-back years).

Table 8.2: Audit Closure Template

AUDIT TEAM:		DATE:
TAXPAYER NAME:		TIN:
		TAX PERIOD:
PHYSICAL ADDRESS:		AUDIT TYPE:
DATE OF COMMENCEMENT:		DATE OF COMPLETION:

TAXPAYER'S NATURE OF BUSINESS & MAIN ACTIVITIES:

MEMBERS OF AUDIT TEAM			
NAME	DESIGNATION	EMPLOYEE ID.NO.	
1			
2			
3			
4			
5			

TAX TYPES COVERED	TAX PERIODS AUDITED

1. AUDIT OBJECTIVE

2. AUDIT SCOPE

3. RISKS IDENTIFIED AT PROFILING AND PLANNING STAGE

4. RISKS IDENTIFIED DURING AUDIT EXECUTION

UNITED NATIONS PRACTICAL MANUAL ON TRANSFER PRICING

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
2006		
2007		
2008		
2009		
2010		
2011		

8. TAXPAYER'S BANK ACCOUNT(S)DETAILS	
BANK NAME	ACCOUNT DETAILS

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

AUDITS AND RISK ASSESSMENT

13. OBSERVATIONS BY TEAM LEADER			

14. ENDORSEMENT BY MEMBERS OF THE TEAM			
NAME	DESIGNATION	SIGNATURE	DATE

Chapter 9

DISPUTE AVOIDANCE AND RESOLUTION

9.1. Dispute Avoidance and Resolution in Domestic and Cross-Border Contexts

9.1.1. Importance

9.1.1.1. Dispute avoidance and resolution procedures are essential to the effective and efficient functioning of all tax administrations. Such procedures, if properly designed and implemented, enable fair and expeditious resolution of differences between tax administrations and taxpayers regarding interpretation and application of the laws. They reduce the uncertainty, expense and delay associated with a general resort to litigation or a failure to provide any recourse. They can also avoid the integrity issues sometimes associated with an over-reliance on ad hoc (case by case) settlements.

9.1.1.2. For the same reasons dispute avoidance and resolution procedures are also of critical importance to taxpayers. This is particularly the case in countries that do not yet have strong and independent judicial systems with adequate expertise in tax matters. Access to effective dispute avoidance and resolution procedures is a key consideration for taxpayers.

9.1.2. Goals of Dispute Avoidance and Resolution Procedures

9.1.2.1. The goal of dispute avoidance and resolution procedures is to facilitate the efficient and equitable determination and collection of tax revenues that are properly due. This should minimize controversy, cost, uncertainty and delay for both tax administrations and taxpayers. The most efficient method of addressing disputes is to prevent them from arising. Tax administrations seeking to use their resources most efficiently should focus in the first instance on procedures for avoiding disputes, while ensuring that appropriate dispute resolution procedures are available should they become necessary.

9.1.3. Particular Challenges in Cross-Border Disputes

9.1.3.1. In the cross-border context, dispute avoidance and resolution procedures are particularly important to avoid double taxation of the same income for a taxpayer or for associated enterprises. They also avoid the imposition of tax not in accordance with the provisions of the applicable tax treaty, if any. In the cross-border context it is necessary for both tax administrations involved in a dispute to give effect to the provisions of any applicable tax treaty and to provide rules and procedures for departing from the domestic law result where necessary to resolve disputes.

9.2. Special Considerations for Developing Countries

9.2.1. Resource Limitations

9.2.1.1. Even the tax administrations of large developed countries often face resource limitations, but such limitations are likely to be much greater for the tax administrations of many developing countries. Such limitations may affect staffing levels, training budgets, access to commercial databases and other research materials, access to outside experts, travel funding and other factors.

9.2.1.2. It should be recognized that such resource limitations may put such developing tax administrations at a real or perceived disadvantage when dealing with better-resourced administrations. Therefore it is 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 administration resources.

9.2.1.3. Efficient dispute avoidance and resolution procedures should benefit taxpayers as well. This 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 to address any audits or disputes that may arise.

9.2.2. Limited Experience so Far

9.2.2.1 Most developing country tax administrations have taken up transfer pricing issues later than many of the larger developed country

administrations. However, India has now been developing and applying transfer pricing principles for a decade, and China, South Africa, Brazil and other countries have quickly acquired substantial expertise. Therefore, bridging the experience gap may be only a matter of time in some cases.

9.2.2.2. The experience over time of those larger developing countries may be of particular assistance to other developing countries. However, smaller developing country tax administrations may face more significant challenges that will require increased training and other capacity building. This is another important reason to design dispute avoidance and resolution procedures that operate as efficiently as possible.

9.3. Dispute Avoidance Procedures: Domestic

9.3.1. Legislation and Guidance

Benefits of transfer pricing legislation and other guidance

9.3.1.1. As in other areas of the law it is important to publish clear guidance in advance regarding any legal requirements that will be applied to transfer pricing. This is equally important both for tax administrations, which need such guidance to apply the law properly and equitably, and for taxpayers, which must comply with the law. Clear guidance can help avoid unexpected results, which pose significant concerns, and thereby minimize controversy.

9.3.1.2. Guidance can serve these purposes only if it is clear and detailed enough to be properly understood by both tax administrations and taxpayers. Countries that have adopted transfer pricing legislation have struck various balances between the provision of general principles and detailed rules in that legislation and accompanying guidance. Where general principles are preferred it is often advisable, for the sake of clarity, to supplement them with examples illustrating their application.

9.3.1.3. 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 throughout the world. As long as this remains the case, departures from the arm's length principle will create an increased risk of double or unexpected taxation, with no realistic prospect of cross-border relief. This could make the costs of doing business in the country concerned prohibitive and 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 acceptance of the arm's length principle internationally.

9.3.1.4. Developing countries whose tax systems are at an early stage of development or face severe resource constraints may choose, for practical reasons, to adopt an approach to transfer pricing that is simplified in comparison to that adopted by more developed countries and recommended by the OECD Guidelines. Where a simplified approach is adopted care should be taken, for the reasons noted above, to avoid results that depart from the arm's length principle. Where a country decides to adopt a simplified approach it may be advisable to re-evaluate that decision periodically. A simplified approach may not continue to meet the needs of the tax administration as it addresses more complex transactions, or the approach may no longer be needed for practical reasons.

Situations in which transfer pricing legislation may not be needed

9.3.1.5. The setting of legislative priorities is obviously a matter for each country to decide for itself, in view of its particular circumstances and policies. Transfer pricing legislation may, for example, not be seen as a first priority by developing countries whose tax systems are still in a relatively early phase of legal development, especially if cross-border trade and investment are not yet significant in volume.

9.3.1.6. Many multinational enterprises apply transfer pricing policies to price their inter-company transactions on a consistent basis globally, so the absence of national legislation may discourage compliance by an MNE.

9.3.1.7. However, where a country that has not adopted specific transfer pricing legislation decides that it is appropriate to challenge a company's inter-company pricing it may find that it lacks a clear legal basis for such a challenge. While some countries may have general legal provisions or principles, such as general anti-avoidance rules or substance-over-form doctrines, they may find it difficult to successfully challenge inter-company pricing on this basis.

9.3.1.8. 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.

9.3.1.9. 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.

9.3.2. Advance Rulings

9.3.2.1. Advance rulings regarding the application of a country's laws to a taxpayer's particular facts (structured as unilateral Advance Pricing Agreements (APAs) in some countries) can often be helpful in avoiding disputes between that taxpayer and the tax administration.

9.3.2.2. Where applicable guidance is not sufficiently detailed the availability of advance rulings may have particular importance to taxpayers.

9.3.2.3. 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.

9.3.2.4. On the other hand where the issue is one of general application it may be less efficient for the tax administration to provide case-specific rulings than to issue general guidance.

9.3.2.5. A heavy reliance on ad hoc rulings may also give rise to integrity concerns and associated equity issues unless there is a robust review process in place.

9.3.2.6. Where guidance is routinely provided by rulings it may prove difficult to strike an appropriate balance between legitimate taxpayer confidentiality concerns and the level of transparency that may be desired. 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 in smaller markets, with negative consequences for the taxpayer's competitive position. It may therefore make sense for tax administrations to use case-specific rulings primarily to provide guidance on issues that are unique, novel, or particularly difficult, or as an interim measure while adequate published guidance is being developed.

9.3.2.7. An alternative means of promoting transparency and consistent treatment of taxpayers, currently 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.

9.3.3. Role of Tax Audit Practices and Policies

9.3.3.1. Tax audit practices and policies play a key role in any effort by a tax administration to avoid or minimize disputes with taxpayers.

9.3.3.2. 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.

9.3.3.3. Conversely, where a tax administration has systemic integrity or confidentiality issues or applies the law in a manner that is not seen as fair and equitable, or is regarded as unpredictable, taxpayers are more likely to see a need to seek resolution of the dispute elsewhere.

9.3.3.4. All tax administrations seeking to avoid or minimize disputes with taxpayers should therefore devote significant attention to

the operation of their tax audit practices and policies. Issues relating to tax audits are discussed in more detail in Chapter 8 of this Manual.

9.3.3.5. Tax administrations may also find it useful to consult the practical guides and information publications issued by tax administration organizations such as the Inter-American Center of Tax Administrations (CIAT)⁷⁷ and the OECD’s Forum on Tax Administration (FTA).⁷⁸

9.3.4. Cooperative Relationships

9.3.4.1. 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 taxpayers and their advisors. The Netherlands and the United Kingdom are widely seen as having already successfully implemented cooperative relationship programmes and other countries such as Nigeria are currently testing this approach on some matters.

9.3.4.2. A cooperative relationship can benefit both tax administrations and taxpayers by offering greater certainty and transparency, an earlier and more efficient 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.

9.3.4.3. From a tax administration perspective interest in a cooperative relationship follows from the understanding that:

⁷⁷More information (in English and Spanish) available from <http://www.ciat.org/index.php/en.html>. CIAT publications cover all matters related 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>

⁷⁸A list of recent OECD publications giving guidance to tax administrations is available from <http://www.oecd.org/ctp/administration/List-of-publications.pdf>. The Forum on Tax Administration’s compilation cover both direct and indirect tax issues, for enterprises of all sizes and high net worth individuals, and include practical information, recommendations, and guides for tax administration staff regarding the structuring and operation of tax administrations, the management of compliance risk and other issues of common interest to tax administrations.

- Effective risk management requires current, relevant, and reliable information regarding the taxpayer's facts and potential tax issues, for which the taxpayer is the best source;
- A cooperative relationship makes the collection of any taxes owed more efficient, saving audit and litigation resources; and
- Tax payments will be received more quickly if disputes are avoided or resolved early in the process.

9.3.4.4. From the taxpayer's perspective a cooperative relationship may be worthwhile because it can:

- Provide greater certainty and predictability regarding the taxation of the taxpayer'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.

9.3.4.5. A cooperative relationship initiative must be carefully implemented to ensure the consistent application of legal provisions, to protect taxpayer rights and to avoid integrity issues. While the manner in which tax administrators, taxpayers and tax advisors deal with each other is modified, applicable tax provisions should continue to be applied impartially.

9.3.4.6. It is also important to implement cooperative relationship initiatives efficiently so that adequate audit resources can be devoted to less compliant taxpayers.

9.3.4.7. Development of a successful cooperative relationship requires that all parties engage based on 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.

9.3.4.8. 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).

9.4. Dispute Avoidance Procedures: Cross-Border

9.4.1. Tax Treaty Provisions

Division of taxing jurisdiction

9.4.1.1. Tax treaties significantly reduce the scope for cross-border disputes. Without a tax treaty, income from cross-border transactions or investment is subject to potential double taxation whenever the laws of the source and residence countries differ. Tax treaties seek to eliminate this double taxation by allocating between the contracting states the taxing jurisdiction over such income and by providing procedures for the relief of any residual double taxation. Treaties also typically require tax laws to be applied without discrimination based on nationality or capital ownership and without discrimination against the conduct of business through a permanent establishment.

9.4.1.2. Treaties therefore offer significant reassurance and certainty to potential investors, as well as greater certainty for tax administrations, by reducing the risk of cross-border disputes.

9.4.1.3. 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.

Interpretive procedures

9.4.1.4. Tax treaties also provide the 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”, MAP enables tax administrations to reach bilateral agreement on issues of general interpretation or application and to thereby avoid double taxation on cross-border transactions and the resulting disputes.

9.4.1.5. These bilateral agreements may relate only to past years, or they may take the form of APAs that provide a transfer pricing methodology for future years (and in many cases past years as well). As discussed in Paragraph 9.6.1. below, the Mutual Agreement Procedure also applies to resolve cross-border disputes that have arisen in particular cases.

Other procedural provisions

9.4.1.6. 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 application 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 associated 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 guidance 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.

9.4.1.7. Developing countries may also want to consider participating in joint audits. These are conducted by two or more tax administrations together to share information, save resources and minimize or expedite the resolution of controversies. 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 a relatively new procedures, but they may prove useful for developing country tax administrations with fewer

resources and less experience or subject-matter expertise in the industry or issues concerned. On the other hand, issues such as differing accounting years and audit cycles may need to be addressed.

9.4.2. Multilateral Agreements

Interpretive guidance

9.4.2.1. Multilateral agreements are important tools to avoid cross-border disputes on transfer pricing and the resulting risks of unrelieved double taxation.

9.4.2.2. As noted above many countries have historically relied primarily on the guidance provided by the OECD Transfer Pricing Guidelines, which interpret Article 9 (Associated Enterprises) of the OECD Model Convention and have been developed by transfer pricing experts over the past several decades. A number of economies in transition and developing countries have adopted domestic transfer pricing laws that extensively draw upon the provisions of the OECD Transfer Pricing Guidelines. These include, for example, China, Egypt, India, Malaysia and South Africa.

9.4.2.3. Although the provisions of Article 9 of the UN Model Convention are very similar to Article 9 of the OECD Model, the interpretation provided by the OECD Transfer Pricing Guidelines may not be fully consistent with the policy positions of all developing countries. However in recent years representatives of China, India, and other non-OECD economies have begun participating actively as observers in the development of transfer pricing guidance at the OECD level. The Commentary to Article 9 of the UN Model also recommends the OECD Transfer Pricing Guidelines to countries generally, although the 2011 Commentary notes that “[t]he views expressed by the former Group of Experts have not yet been considered fully by the Committee of Experts, as indicated in the Records of its annual sessions”.⁷⁹ Therefore, developing countries may wish to consider the relevance of

⁷⁹Please refer to the Commentary to Article 9, under A. General Considerations, 3. Available from http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf

the OECD Transfer Pricing Guidelines, along with the growing body of UN guidance and other available sources, when establishing their own domestic and cross-border policies on transfer pricing.

Procedural provisions

9.4.2.4. This Manual contains a great deal of procedural guidance that should help avoid disputes, particularly in its discussion of tax audits at Chapter 8.

9.5. Dispute Resolution Procedures: Domestic

9.5.1. Audit Settlements

9.5.1.1. Many tax administrations, both developing and developed, rely heavily on case by case audit settlements to resolve disputes with taxpayers. While this may seem to be the most effective use of limited resources, such an approach is not transparent, is not necessarily coordinated to provide similar treatment to similarly situated taxpayers and is therefore not always perceived as fair by stakeholders. It may also raise more integrity issues than some other procedures.

9.5.1.2. Developing countries seeking to reassure current and potential investors should consider developing the supplemental domestic dispute resolution procedures discussed below, in addition to cross-border procedures where possible.

9.5.2. Administrative Appeals

9.5.2.1. 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.

9.5.2.2. 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 peers of the colleagues whose assessments are being appealed.

9.5.2.3. 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 conditions) are decided by the CARF. The CARF is housed within the Ministry of Finance but is separate from the tax administration, even though that is part of the same ministry.

9.5.3. Judicial System

9.5.3.1. An independent judicial system that gives unbiased consideration to cases can do much to improve a country's reputation among investors as a jurisdiction where tax disputes can be fairly resolved.

9.5.3.2. However owing to the call in the modern business world for real-time certainty regarding tax obligations the perceived benefit of such a judicial system declines as the length of time to obtain a final decision grows. It is therefore important to ensure that the judicial system has adequate resources and that it is not unduly burdened by tax disputes due to real or perceived deficiencies at the audit and administrative appeals stages.

9.6. Dispute Resolution Procedures: Cross-Border

9.6.1. Mutual Agreement Procedure under Tax Treaties

Overview of MAP procedures

9.6.1.1. The 2011 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 pricing and other disputes.

9.6.1.2. The UN Committee of Experts has adopted a Guide to the Mutual Agreement Procedure under Tax Treaties, which will provide

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.⁸⁰

9.6.1.3. Some tax administrations including those of Canada,⁸¹ Germany, India, Japan,⁸² the Netherlands, the United States⁸³ and the United Kingdom⁸⁴ as well as the Pacific Association of Tax Administrators (PATA)⁸⁵ have published detailed internal MAP procedures. These may also provide useful comparative information for tax administrations with less MAP experience to date.

9.6.1.4. 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.

9.6.1.5. Some countries, especially civil law countries, may have difficulty in implementing or improving MAP, bilateral APA, and similar programmes. In such cases, it may be advisable to enact a law allowing for such procedures and, if necessary, an amendment to the constitution, in order to provide juridical certainty to such procedures.

⁸⁰The 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 MAP under bilateral tax treaties and to identify best practices for MAP.

⁸¹More information available from http://www.cra-arc.gc.ca/tx/nrs-dnts/cmp/mp_rprt_2011-2012-eng.html

⁸²More information available from http://www.cra-arc.gc.ca/tx/nrs-dnts/cmp/mp_rprt_2011-2012-eng.html

⁸³More information available from http://www.irs.gov/irm/part4/irm_04-060-002.html

⁸⁴More information available from <http://www.hmrc.gov.uk/international/map.htm>

⁸⁵More information available from http://www.irs.gov/pub/irs-utl/pata_map_guidance_-_final.pdf

Structural considerations

9.6.1.6. The purpose of a MAP programme is to provide an effective means of reconciling differing positions of treaty partners, so that the treaty can operate as intended to avoid double taxation or other taxation not in accordance with the provisions of the treaty. Experience has shown that this purpose can best be achieved if the MAP programme is structured so that tax administrators implementing the MAP programme are able to make decisions independently of those implementing the audit programme and are free from outside influence.

9.6.1.7. Structural independence can 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 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.

9.6.1.8. Freedom from political influence on the MAP process is equally important. Many tax administrations have found that this can be best achieved by placing the MAP function within the tax administration, rather than within the Ministry of Finance or other tax policy-making function. They believe it is helpful to establish procedures or practices preventing involvement by those outside the tax administration in decisions regarding particular MAP cases. In the United States, for example, the Department of the Treasury follows a long-standing policy of not intervening in particular MAP cases even when asked to do so by taxpayers or their representatives, and carefully limits its involvement in MAP matters to general policy-level procedural issues. Other countries believe that placing the MAP function within the Ministry of Finance is preferable, to reduce undue influence by the tax administration, or to facilitate coordination by policy makers.

Operational considerations

9.6.1.9. Given their purpose, it is important for MAP procedures to be operated in a consistent manner rather than handling each case in an ad hoc fashion. This will provide for similar treatment of similarly situated taxpayers and help the MAP programme to be viewed as

equitable and effective. Both operational structure and training and other capacity building of the workforce can play important roles in promoting such consistency.

9.6.1.10. 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.

9.6.1.11. 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 discourage the use of MAP, including unreasonable time limitations or unilateral attempts to exclude selected issues from MAP. Consideration should be given to suspending the collection of disputed tax assessments 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 prevent 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.

9.6.2. Advance Pricing Agreements

Policy considerations

9.6.2.1. Since the initiation of Advance Pricing Agreement (APA) programmes in the early 1990s by Japan and the United States many tax administrations have found APAs to be an effective tool for providing advance transfer pricing guidance to taxpayers and greater certainty to both tax administrations and taxpayers. In many countries

both the tax administration and taxpayers tend to have a strong preference for APAs over 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 has implemented an APA programme in July 2012.

9.6.2.2. APAs have been used in many cases to resolve disputes for past years as well, sometimes addressing 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, especially for large or complex cases. It is possible to limit APAs to future years only, but this is less common, perhaps because it limits the tax administration's ability to fully leverage the resources it invests in concluding the APA.

9.6.2.3. 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.

9.6.2.4. As the taxpayer provides extensive information in advance, the APA process is usually efficient in determining relevant facts. Perhaps for this reason many tax administrations have a general practice of suspending examination activity during APA discussions. Tax administrations may wish to clarify in their APA procedures that all information pertaining to the APA request should be shared simultaneously with both countries.

9.6.2.5. Tax administrations have also found APAs to be useful tools for developing a deeper understanding of business operations, which can be used to inform their general guidance and examination processes. Most tax administrations have found that APAs are more widely embraced if APA and examination functions are kept separate. Alternatively, they may impose limitations on the use of some or all of the information provided by the taxpayer in the APA discussions for other purposes such as subsequent examinations or future litigation if an APA cannot be successfully concluded.

9.6.2.6. 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.

9.6.2.7. 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

9.6.2.8. It is important to establish an appropriate operational framework for an APA programme, to promote a consistent, principled approach and to ensure adequate review.

9.6.2.9. 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 transparency. If, due to resource limitations, APA programmes need to draw on expertise from other parts of the tax administration it is important to establish safeguards to ensure that the APA process is not managed in the same way as a typical audit proceeding. Otherwise many of the benefits typically enjoyed by tax administrations in APA proceedings may be lost.

9.6.2.10. At the same time it is important to ensure that the APA programme operates in an appropriate manner within the framework of the tax administration as a whole. Procedures should be set up, for example, to prevent the APA programme from being used primarily to challenge the position of an audit team for past years. This may be achieved by requiring that the APA applies primarily to future years rather than past years.

9.6.2.11. Organizationally most tax administrations have tended to manage their APA programmes together with their MAP programmes and to organize them so that all cases with a particular treaty partner are handled by the same team. This facilitates the formation of closer working relationships between the teams from the two countries and promotes a better understanding of the other country's economy, legal provisions and administrative procedures. On the other hand benefits may also be derived by comparing experiences on different cases within an industrial sector or by comparing the approaches of various treaty partners to similar issues. It is also important to establish procedures to facilitate the sharing of such knowledge, to strengthen technical analysis and to provide consistent treatment.

9.6.2.12. Most tax administrations have found that an APA term of approximately five future years strikes the best balance between efficient use of resources and the uncertainties associated with prospective agreements. The risks associated with uncertainties can be minimized by specifying certain conditions, sometimes referred to as "critical assumptions" in which the APA will be renegotiated. It is fair to expect a renegotiation if the applicable law or the covered transactions change materially, but care should be taken not to impose excessively strict requirements on the continued application of an APA.

9.6.2.13. 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-size enterprises (SMEs). A 2011 OECD survey of OECD member and observer countries found that a number of countries 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.⁸⁶ These programmes generally require SME taxpayers to provide less information and may also lower the application fee, if there is one.

9.6.2.14. Some administrations charge taxpayers user fees for the conclusion of an APA, as a means of funding the programme. If reasonable in amount these fees have generally been accepted by taxpayers as outweighed by the advantage of the certainty provided by the APA. To avoid integrity issues it is important that the fees be charged on a consistent basis (ideally reduced for small taxpayers), that they are paid into government funds and that they are refunded in the rare circumstances where an APA cannot be concluded.

9.6.2.15. The Guide to the Mutual Agreement Procedure under Tax Treaties provides much more guidance on best practices in the structuring and operation of APA programmes, which was approved by the Committee in October 2012.⁸⁷

9.6.2.16. Tax administrations may also want to refer to the Manual on Effective Mutual Agreement Procedures,⁸⁸ the Annex to Chapter IV: Guidelines for Conducting Advance Pricing Arrangements under the Mutual Agreement Procedure (MAP APAs) of the OECD Transfer Pricing Guidelines,⁸⁹ and to the work of the EU Joint Transfer Pricing Forum on dispute resolution and APAs.⁹⁰ Finally, some national tax

⁸⁶OECD, “Multi-Country Analysis of Existing Transfer Pricing after Simplification Measures”, 10 June 2011. Available from <http://www.oecd.org/tax/transfer-pricing/48131481.pdf>

⁸⁷The Guide is available from http://www.un.org/esa/ffd/tax/gmap/Guide_MAP.pdf

⁸⁸More information available from <http://www.oecd.org/tax/dispute/manualoneffectivemutualagreementproceduresmemap.htm>

⁸⁹More information available from <http://www.oecd.org/ctp/transfer-pricing/transferpricingguidelinesformultinationalenterprisesandtaxadministrations.htm>

⁹⁰Communication 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 http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&ty pe_doc=COMfinal&an_doc=2007&nu_doc=71&lg=en

administrations, including those of Canada, India,⁹¹ Japan, the United Kingdom⁹² and the United States⁹³ as well as the Pacific Association of Tax Administrators (PATA)⁹⁴ have published detailed internal APA procedures. These may also provide useful comparative information.

9.6.3. Other Dispute Resolution Programmes

Mediation/Conciliation

9.6.3.1. Mediation and conciliation are sometimes mentioned as potential procedures to resolve cross-border disputes. Mediation has proven successful in resolving disputes between some EU member states. While it may be worth testing these approaches it is not clear whether they can be generally effective in a cross-border context. The negative experiences of countries that have adopted voluntary arbitration provisions, in which either country may decline to participate or to accept the arbitration decision, might indicate that other voluntary procedures such as mediation or conciliation are not likely to be generally successful.

Arbitration

9.6.3.2. Mandatory arbitration provisions have been added to many treaties in recent years as a last resort method of resolving MAP issues that cannot be resolved by the competent authorities within a specified time frame. The European Union began this trend in 1990 with the multilateral EU Arbitration Convention and the OECD amended its Model Convention and Commentary in 2008 to recommend the inclusion of mandatory arbitration provisions in bilateral tax treaties.

9.6.3.3. Current OECD statistics show that the MAP process succeeds in avoiding double taxation in 90 to 95 per cent of the cases to

⁹¹More information available from <http://www.itatonline.org/info/index.php/cbdts-advance-pricing-agreement-guidance-with-faqs/>

⁹²More information available from <http://www.hmrc.gov.uk/manuals/intmanual/intm469005.htm>

⁹³More information available from <http://www.irs.gov/pub/irs-drop/rp-06-9.pdf>

⁹⁴More information available from http://www.irs.gov/pub/irs-utl/pata_bapa_guidance_-_final.pdf

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, especially given the growing amounts in controversy. Both taxpayers, and competent authorities, tend to view arbitration very much as a last resort. However, the inclusion of these arbitration provisions in treaties has been widely supported by taxpayers as they guarantee resolution within a specified time frame and provide certainty that double taxation will be avoided.

9.6.3.4. In the vast majority of cases the practical effect of mandatory arbitration provisions has been to encourage the competent authorities to reach agreement by the specified deadline. Only a handful of cases out of the many hundreds of MAP cases submitted have been taken to arbitration under agreements concluded thus far.

9.6.3.5. 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 at the 2010 Annual Session of the UN Committee of Experts on International Cooperation in Tax Matters most participants from developing countries expressed potential interest in tax treaty arbitration procedures for the future but a reluctance to adopt arbitration at this time. This led the Committee to endorse arbitration as an option but not an affirmative recommendation.

9.6.3.6. 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 arbitration by developing countries. These arguments are summarized below together with other considerations that have been identified by members of the Subcommittee on Transfer Pricing.

9.6.3.7. It has been suggested that mandatory tax treaty arbitration may have the following potentially negative consequences from a developing country perspective:

- Developing countries may feel compelled to reach agreement in MAP in order to avoid arbitration because they

cannot afford the costs and foreign exchange requirements of arbitration 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, air fares, accommodation 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 arbitral 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 familiar with developing countries' concerns and issues, and even more difficult those that actually are from developing 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 constitutionally possible to bind one's country to an arbitrated result.

9.6.3.8. 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 country 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 taxpayers 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, limiting 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 centrally 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 independent arbitrator may be better able to see that this is the case than a less experienced developing country competent authority analyst. Therefore arbitration may be a way of levelling the playing field for developing countries;
- Advocates of arbitration believe that there are sufficient qualified, independent arbitrators, including experts from developing 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.

9.6.3.9. In view of these differences, the 2011 UN Commentary added arbitration as an option under one version of Article 25, with certain adjustments to the OECD approach to address issues that have

been identified by developing countries. Transfer pricing issues were at the forefront of discussion on arbitration issues in the Committee so the results of those discussions are especially relevant in this area.

9.7. Coordination of Domestic and Cross-Border Dispute Resolution Procedures

9.7.1. Each country will have its own domestic dispute resolution procedures in addition to cross-border procedures. It is important that these be properly coordinated for two reasons.

9.7.1.1. First, tax administrations, especially developing country administrations with limited resources, may want to minimize duplication of effort by avoiding the simultaneous operation of two parallel dispute resolution processes. Most tax administrations prefer to deal with an issue either through MAP or through domestic procedures, but do not generally operate both procedures simultaneously (with the exception of certain simultaneous MAP and domestic appeals programmes).

9.7.1.2. Second, notwithstanding such resource concerns, it is important to manage any duplication issues without forcing taxpayers to make a premature choice between domestic and cross-border procedures. For example, taxpayers should not be required to give up their MAP rights under treaties in order to access domestic administrative appeals procedures. To avoid such results, while addressing resource constraints, many tax administrations permit taxpayers to preserve their rights to domestic procedures during MAP discussions by placing them on hold (usually after filing an initial notice of objection) so that they can later pursue their domestic rights if no MAP agreement is reached. Alternatively tax administrations may wish to provide flexibility in the timing of MAP 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.

9.7.1.3. Taxpayers should be permitted, however, to pursue MAP consideration of a relevant cross-border issue or issues while pursuing domestic resolution procedures for separate issues that are not appropriate for MAP.

9.7.1.4. In some countries there is a view that the tax administration, including the Competent Authority, is bound by a final decision of a domestic court and that MAP consideration is not available in such circumstances. Some other countries view this as inconsistent with the obligations of the treaty MAP provisions. Where a Competent Authority takes the view that it cannot or should not depart from domestic court decisions it should clearly state this position in public guidance for the information of treaty partners and taxpayers.

9.7.1.5. The Competent Authority of one country is, of course, not obligated in any way to accept either a court decision or an administrative settlement of another country. 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.

Chapter 10

COUNTRY PRACTICES

10.1. Preamble by the Subcommittee on Transfer Pricing: Practical Aspects

10.1.1. In the first nine chapters of this Manual, the Subcommittee has sought to provide practical guidance on the application of transfer pricing rules based on Article 9(1) of the UN Model Tax Convention and the arm's length principle embodied in that Article. With regard to chapters one through nine, the Subcommittee has discussed and debated the merits of the guidance that is provided and, while there may be some disagreement on certain points, for the most part the Subcommittee is in agreement that the guidance in those chapters reflects the application of the arm's length principle as embodied in the UN Model Tax Convention.

10.1.2. The Subcommittee recognizes that individual countries, particularly developing and emerging economies, struggle at times with the details of applying these treaty-based principles in a wide variety of practical situations. It therefore seemed appropriate to allow representatives of individual countries an opportunity to set out their individual country viewpoints and experiences for the information of readers. Those individual country views are contained in this chapter. It should be emphasized that it does not reflect a consistent or consensus view of the Subcommittee.

10.2. Brazil Country Practices⁹⁵

10.2.1. Introduction: General Explanation

10.2.1.1. Brazil introduced a law on transfer pricing, through Law n. 9430/1996, in 1996.⁹⁶ The bill was proposed to deal with tax evasion through transfer pricing schemes, and according to the proposal, it adopted the arm's length principle.

10.2.1.2. The methodology introduced by the law listed the traditional transaction methods (Cost Plus Method and Resale Price Method) but denied the use of transactional profit methods (the Profit Split Method and Transactional Net Margin Method) and formulary apportionment. Regarding the CUP Method, for export or imports, the law introduced a methodology that is similar to OECD practices. However, with regard to the Cost Plus Method and Resale Price Method, instead of making use of comparable transactions, the law established fixed margins for gross profits and mark-up.

10.2.1.3. For a period of time the fixed margin for the Resale Price Method was 20 per cent. Later the law was changed to provide for either 20 or 60 per cent (the 60 per cent margin applied to situations where the imports were subject to manufacturing in Brazil). In 2012, the law was changed by adopting different margins for certain specific sectors, but in general maintained 20 per cent as a prescribed margin. The Brazilian perspective is that the conventional use of the Resale Price Method and the Cost Plus Method implies some uncertainty and juridical instability, since they are implemented by the taxpayer without previous consent or summary review by the tax authorities. This affects stability and expectations in economic and fiscal relations.

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⁹⁶Law n. 9430/1996 was modified by Law 9.959/2000, Law n. 10.451/2002, Law n. 11.727/2008, Provisional Measure n. 478/2009, and more recently by Provisional Measure n. 563/2012, converted into Law n. 12.715 of 17 September 2012.

10.2.1.4. Brazil's Resale Price Method and Cost Plus Method with fixed margins are applicable to both export and import operations. In order to make it easier to understand, they are presented in the following paragraphs disregarding practical distinctions. A more detailed explanation to differentiate the application from import and exports and how to deal with that will be discussed separately. This is because the Brazilian transfer pricing law details the application of the two methods (RSP and CPM) for exports and imports in a separate set of rules. There are also specific methods for tradable commodities and interest that are addressed in part 10.2.3. of this Chapter.

10.2.1.5. Brazil's Resale Price Method and Cost Plus Method with fixed margins are not 'safe harbour' methods. For these purposes, safe harbours mean provisions that apply to a defined category of taxpayers or transactions that relieve eligible taxpayers, at their own option, from certain obligations in pricing controlled transactions otherwise applicable under the arm's length standard. The Resale Price Method and Cost Plus Method with fixed margins can be applied by the taxpayers. The fixed margins are subject to the modifications authorized by the Minister of Finance, discussed below.

10.2.2 Resale Price Method with Fixed Margins

Explanation of the methodology

10.2.2.1. The mechanism of the Resale Price Method using fixed gross profit margins is considered by Brazil to be similar to the conventional Resale Price Method with margins, except that the gross margins are asserted, rather than being based on comparables. See Figure 10.1 below. In order to determine the transfer price (deemed arm's length price, or parameter price, as called in Brazilian transfer pricing laws), the resale price that the reselling company (Associated Enterprise 2) charges to an unrelated customer (Independent Enterprise) is reduced by a fixed gross profit margin. The remainder is the acceptable transfer price between associated parties (Associated Enterprise 1 and Associated Enterprise 2), which is the parameter price.

10.2.2.2. Reference is made below to two applications of how this method could be implemented for transfer pricing of products,

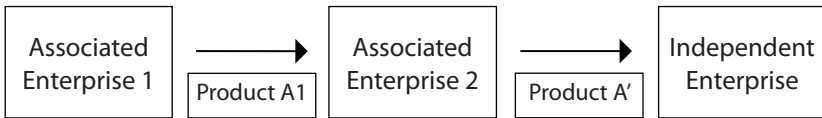
including cases where the product is subject to manufacturing activities (value added costs) before it is resold.

10.2.2.3. The method is based on the participation of transferred goods in the product that is resold (which is 100 per cent in a simple resale). Then the parameter price will be the resale price participation less a profit margin, fixed by law. Therefore, this methodology is also feasible to apply when other inputs (bought from independent companies) are combined with the input traded between associated enterprises and the final good, manufactured from these different sources of inputs, is resold by a Brazilian enterprise.

10.2.2.4. Resale Price (without manufacturing)

If the product traded between related parties is not subject to any manufacturing modifications, the formula adopted will be the same and the participation ratio will be 100 per cent, since the price of product A will be equal to the resale cost of product A’:

Figure 10.1: Resale Price Method (without manufacturing)



Appropriate Price?	Price is Given
(Net) Resale Price	= \$10 000
<u>Participation Ratio (of Product A1 in Product A')</u>	= <u>100%</u>
Participation Value (of Product A1 in Product A')	= \$10 000

10.2.2.5. In this case the calculation is simple, the parameter price (deemed arm’s length price) is the resale price of the same product (charged between independent parties) reduced by: unconditional discounts granted; taxes and contributions on sales; commissions and brokerage fees paid; and a fixed profit margin of, for example, 20 per cent (according to current Brazilian law).

$$TP \text{ (parameter price)} = NRP - GPM \times NRP,$$

Where:

- TP (parameter price) = transfer price determined by Brazilian law. The maximum price on imports or the minimum price on exports;

- NRP = net resale price;
- GPM = gross profit margin = the value of gross profit margin ratio, as determined by law or tax regulations (30 per cent) in this simplified example); and
- TP (parameter price) = $NRP - GPM \times NRP = NRP - 20\% \times NRP = 80\% \text{ NRP}$.

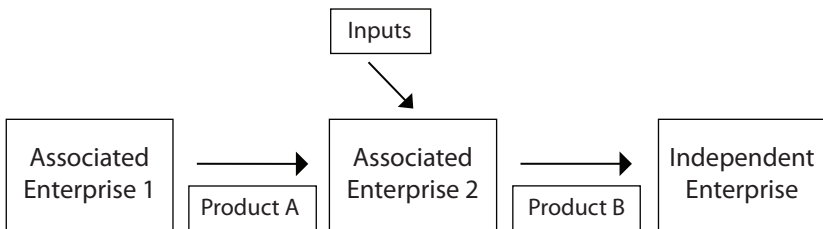
Hence:

- (Net) resale price = \$10 000
- — Resale Price Margin (20%) = 2 000
- A1 Transfer Price under Brazilian law = 8 000

10.2.2.6. Resale Price (with manufacturing operation)

In this methodology the transfer price would be calculated having regard to the proportional participation of the goods negotiated between associated parties (product A = input) in the goods resold to an independent enterprise (product B). This methodology reduces the weakness of using the Resale Price Method when the reseller adds substantial costs to the product traded between associated parties. The resale price to be considered shall be that price agreed upon by the reselling company with an independent enterprise.

Figure 10.2: Resale Price Method (with manufacturing)



Appropriate Price?	Price is Given
(Where Product A is an input for Product B) =	
(Net) Resale Price =	\$10 000
<u>Participation Ratio (of Product A in Product B)</u> =	<u>60%</u>
Participation Value (of <u>Product A</u> in <u>Product B</u>) =	6 000
(Where Product A is an input for Product B) =	
(Net) Resale Price =	\$10 000

<u>Participation Ratio (of Prod. A in Product B)</u>	=	<u>60%</u>
Participation Value (of Prod. A in Product B)	=	6 000
— <u>Resale Price Margin (30%)</u>	=	1 800
Parameter Price	=	4 200

Resale Price (with manufacturing operation)

10.2.2.7. In this more elaborated approach, the parameter price (deemed to be the arm’s length price) would be the difference between the *participation value* of the sale price of goods (Product A) in the net resale price (Product B) less its “*gross profit margin*” participation. For this purpose, the *participation value* of Product A in the net resale price (Product B) would be: the application of the *participation ratio* of the input (Product A) to the total cost of the Product B multiplied by the *net resale price* (of Product B).⁹⁷

10.2.2.8. The above-mentioned *participation ratio* is determined as follows: The ratio of the price of Product A (input) to the total cost of the good resold (Product B), calculated according to the company’s cost spreadsheet. The *net resale price* is the weighted average price of sales of the goods resold (Product B), less unconditional discounts granted, indirect taxes on sales, and commissions and brokerage fees paid. “Unconditional discounts” are those that do not depend on future events and that are detailed in the invoice.

10.2.2.9. The *gross profit* of Product A (in the resale of Product B) is the application of, for example, 30 per cent (gross profit margin) on the *participation value* referred above. As mentioned before, in this approach the gross profit margin will be provided by law. See Figure 10.1. The 30 per cent margin may vary depending on the economic sector of the activity performed by the Associated Enterprise 2.

10.2.2.10. In order to avoid distortions between companies operating within Brazil, it is necessary to obtain accounting uniformity between taxpayers in the country. If certain expenses are characterized as operating expenses by some companies and costs of goods sold by others, the system will not be satisfactorily implemented.

⁹⁷It should be noted that the participation ratio has nothing to do with the fixed margin but depends on the cost of imported inputs and the COGS, see 10.2.2.8

The formula for the inter-company transfer price would be (for a 30 per cent margin):

TP (parameter price) = PV – GPMV,

Where:

- TP (parameter price) = deemed arm's length transfer price determined under Brazilian law. The maximum price on imports or the minimum price on exports.
- PV = participation value of the goods transferred to the associated enterprise in the net resale price = (price of Product A ÷ cost of Product B) x (net resale price of Product B);
- GPM = gross profit margin = the value of gross profit margin ratio, as determined by law or tax regulations (30% in this example).
- GPMV = GPM x PV = GPM x (price of Product A ÷ cost of Product B) x (net resale price of Product B) = 30% (price of Product A ÷ cost of Product B) x (net resale price of Product B).
- TP (parameter price) = PV – GPMV = ((price of Product A ÷ cost of Product B) x (net resale price Product B)) – 30% x ((price of Product A ÷ cost of Product B) x (net resale price Product B)) = PV (1 – GPM)

Fixed margins for the Resale Price Method

10.2.2.11. According to recent changes in the Brazilian transfer pricing legislation the margins for the RSP Method for imports are as follows (it includes simple resale operations and manufacturing operations):

I — **40 per cent**, for the following sectors:

- Pharmaceutical chemicals and pharmaceuticals;
- Tobacco products;
- Equipment and optical instruments, photographic and cinematographic;
- Machinery, apparatus and equipment for use in dental, medical and hospital;
- Petroleum, and natural gas (mining industry), and
- Petroleum products (derived from oil refineries and alike);

II — **30 per cent** for the following sectors:

- Chemicals (other than pharmaceutical chemicals and pharmaceuticals);
- Glass and glass products;
- Pulp, paper and paper products; and
- Metallurgy; and

III — **20 per cent** for the remaining sectors.

10.2.2.12. In order to apply such margins, the law also states that in the event that the company engages in activities described in more than one of the categories mentioned above (I, II and III), the margin that should be adopted to apply the RSP Method is the margin corresponding to the activity sector to which the imported goods are intended to be used. In the event of the same imported goods being sold and applied in the production of one or more products, or in case the imported goods are subjected to different manufacturing processes in Brazil, the final price parameter is the weighted average of the values found by applying the RSP Method, according to their respective destinations.

10.2.2.13. For exports the applicable margins in the foreign country are: 15 per cent for wholesale, and 30 per cent for retail sales.

10.2.2.14. The Minister of Finance, ex officio (that is, by his or her own volition), or under request, is authorized by law to modify these margins. A request for modification presented by a taxpayer must be fully justified, and supplied with the proper documentation as established in the law.

10.2.2.15. Example 1: Resale of Same Product

A manufacturing enterprise domiciled in Country X, MCO, sells Product A with no similar product available worldwide to an exclusive distributor domiciled in Brazil, YD, for \$16,000 per unit. YD, in its turn, resells the same Product A to customers for \$18,750. According to the transfer pricing rules of Brazil, the Resale Price Method provides for a 20 per cent gross profit margin (\$3,750). Therefore, the transfer price applicable to the transaction between MCO and YD would be up to \$15,000 on import and, on the other hand, at least \$15,000 on export. Thus for YD, the buyer, there will be a transfer pricing adjustment of \$1,000 per

unit (\$16,000 – \$15,000). On the other hand, if the method was applied by Country X for MCO, the seller, no transfer pricing adjustment would be necessary.

10.2.2.16. Example 2: Different Products, with manufacturing operation

A controlling enterprise domiciled in Country A, HOLDCO, sells inputs to a subsidiary domiciled in Brazil for \$400 per unit. In its turn, the subsidiary manufactures final products that are to be sold to local customers at \$1,200 per unit (net resale price). Along with the inputs acquired from HOLDCO, the subsidiary also uses other inputs, acquired in the host country, in the industrialization process of the final product. The cost of such additional inputs corresponds to 60 per cent of the total cost of the final product, and so the participation ratio of the input sold by HOLDCO is 40 per cent (\$400), thus the total cost is \$1000. The Resale Price Method in Country B imposes a fixed margin of 30 per cent in order to calculate the applicable transfer price. Based on the information above, the calculation is as follows:

$$\text{PV} = \text{participation value of the good transferred to the associated enterprise in the net resale price} = (\text{price of Product A} \div \text{cost of Product B}) \times (\text{net resale price of Product B}) = \$400/\$1000 \times \$1200 = \$480;$$

GPM = 30% in this example

$$\text{GPMV} = \text{GPM} \times \text{PV} = \$480 \times 30\% = \$144$$

Thus, the parameter price (deemed to be the arm's length price) = $\text{PV} - \text{GMPV} = \$480 - \$144 = \336 .

As a consequence, the subsidiary should pay for imported inputs sold by HOLDCO up to \$336 per unit in order to comply with transfer pricing rules. Thus there would be an adjustment per unit of \$64 per unit (\$400 – \$336).

10.2.2.17. Example 3: Intercompany Software Licenses

SIRFRO, a service provider domiciled in Country A, in Europe, exports licenses of unique software to its affiliated company established in Brazil,

named SARPRO. Each software license agreement grants the affiliated company not only the right to use the software but also to sublicense it within their respective territory. As a result, SIRFRO charges SARPRO a monthly royalty fee of \$140,000, while it makes \$160,000 out of sublicense agreements per month. According to the transfer pricing rules of Brazil, the parameter price (deemed to be the arm's length price) in transactions like the one performed by SIRFRO shall be calculated by decreasing a 20 per cent fixed gross margin of the sublicense price resold. Thus the parameter price would be equal to \$160,000 minus \$160,000 x 20%, which is \$128,000. Thus the transfer pricing adjustment would be \$12,000 per month (\$140,000 – 128,000) to SARPRO's tax basis, in Brazil. In Country A, the royalties charged by SIRFRO on monthly basis should correspond to \$128,000, at least, in order to comply with the Resale Price Method.

10.2.3. Cost Plus Method With Fixed Margins

10.2.3.1. Explanation of the methodology:

Similar to the Resale Price Method with fixed margins, the Cost Plus Method may be used with a predetermined gross profit mark-up. The basic functionality of this method is similar to the non-predetermined margin (or traditional) Cost Plus Method except that the gross margins are asserted, rather than based on comparables. The method focuses on the related product manufacturing or service providing company in transfer pricing with associated enterprises. As explained above, the parameter price (deemed to be the arm's length price) is reached by adding a predetermined cost plus mark-up to the cost of the product or services. This will be a maximum value on imports or a minimum value on exports.

10.2.3.2. Unlike the Resale Price Method, the Cost Plus Method with predetermined fixed gross profit mark-ups does not require the taxpayer to calculate the ratio of certain inputs to the final product. Thus, the gross profit mark-up is applied to the costs as a whole to determine the parameter price. See Figure 10.3 below.

The calculation formula is:

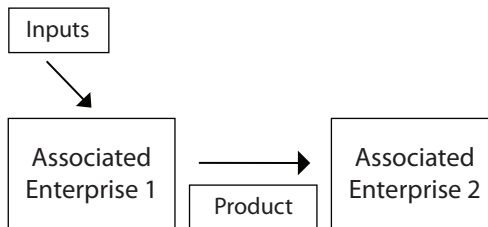
$$\text{TP (parameter price, which is deemed to be the arm's length price)} = \text{PC} + \text{GPM} \times \text{PC} = \text{PC} \times (1 + \text{GPM})$$

Where

- TP (parameter price) = transfer price determined by Brazilian law. The maximum price on imports or the minimum price on exports.
- GPM = gross profit mark-up, as determined by law or tax regulations (20 per cent in this simplified example, which is the fixed gross profit mark-up for export operations according to Brazilian law).

This method may be also applied for cases where the product is not subject to substantial modification, that is, where Associated Enterprise 1 merely resells the product to Associated Enterprise 2. This method can also be used for services and intangibles, however the existence of cost sharing agreements in the latter case will make it more complex to apply.

Figure 10.3: Cost Plus Method



Appropriate Price?

Parameter Price	=	\$6 000
Cost of Associated Enterprise 1	=	5 000
+ <u>Gross Profit Mark-up (20%)</u>	=	<u>1 000</u>

Fixed margins for the Cost Plus Method

10.2.3.3. Brazilian transfer pricing law provides two sets of fixed gross profit mark-ups for the Cost Plus Method, depending on whether import or export operations are being addressed. For export operations the fixed gross profit mark-up is 15 per cent, and for imports it is 20 per cent (which is the required gross profit mark-up for the export country).

10.2.3.4. The Minister of Finance, ex officio, or by request, is authorized by law to modify these margins. A request presented by a taxpayer must be fully justified, and supplied with the proper documentation as established in the law.

10.2.3.5. Example: Intercompany Distribution

PHARMAX, a pharmaceutical industry with headquarters in Brazil, acquires the active ingredient of a drug produced in its laboratories from an independent enterprise. The price paid in the acquisition of the active ingredient is \$100 per unit, while PHARMAX exports medicine to companies in the same MNE group for \$120 per unit. The Cost Plus Method in Brazil requires the exporter to stipulate prices taking into consideration a 30 per cent gross profit mark-up so as to comply with transfer pricing rules. As a result, from Brazil's perspective, PHARMAX should not sell medicine to its affiliates in the other countries for less than \$130 per unit, thus there would be a transfer pricing adjustment of \$10 per unit (\$130 – \$120).

10.2.4. Differences Between the Application of the Methods Regarding Import and Export Operations

The RPM and CPM with fixed margins are applicable both to export and import operations. Considering the RSP with fixed margins, depicted in Figures 10.1 and 10.2 of this Chapter, it would be applicable in the country of Enterprise 1 for export operations, and in the country of Enterprise 2 for import operations, hence:

- For exports: $TP \text{ (parameter price)} > PV - GPM$, which means that $(PV - GPM)$ is the minimum acceptable transfer price for tax basis calculation.
- For imports: $TP \text{ (parameter price)} < PV - GPM$, which means that $(PV - GPM)$ is the maximum acceptable transfer price for tax basis calculation.

Considering the CPM with fixed margins, in Figure 10.3 of this Section, it would be applicable in the country of Enterprise 1 for export operations, and in the country of Enterprise 2 for import operations, hence:

- For exports: TP (parameter price) > PC (1 + GPM), which means that PC (1 + GPM) is the minimum acceptable transfer price for tax basis calculation.
- For imports: TP (parameter price) < PC (1 + GPM), which means that PC (1 + GPM) is the maximum acceptable transfer price for tax basis calculation.

However, due to information accessibility RPM is usually more suitable when the Brazilian company imports and CPM is usually more suitable when the Brazilian company exports, as explained below.

10.2.5. Imports

10.2.5.1. Considering the case where the product resold is subject to value added costs or manufacturing by the reselling associated enterprise, the RPM is normally more useful for imports than for exports. The reason for this is that companies may not disclose their production or manufacturing costs, even to other associated companies located in Brazil. This aspect would jeopardize the method's applicability for exports, because the necessary manufacturing cost data incurred by the associated importing enterprise would be unavailable for the associated Brazilian exporting enterprise and the Brazilian tax administration. Even if the enterprises involved have complete access to each other's books, there is still a problem of information availability to the Brazilian tax administration.

10.2.5.2. If the RPM Method is applied for import transfer pricing, the manufacturing importer uses its own account book costs to calculate the correct transfer price, with no need to request the cost data incurred by the exporting associated enterprise. Furthermore in case of imports, the tax administration has full access to evaluate the uncontrolled operations (with independent enterprises). As a result, the Resale Price Method with fixed margins is recommended for import operations.

10.2.6. Exports

10.2.6.1. For the corresponding reasons mentioned above as regards the Resale Price Method, the CPM is more useful for exports than for imports. Companies may not disclose their production or

manufacturing costs, even to other associated companies located in Brazil, which jeopardizes the method applicability for imports, because the necessary manufacturing cost data incurred by the associated exporting enterprise may be unavailable for the associated Brazilian importing enterprise. Even if the enterprises involved have complete access to each other's books, there is still a problem of information accessibility to the Brazilian tax administration.

10.2.6.2. If the CPM is applied for determining the export transfer price, the Brazilian manufacturing exporter uses its own booked costs to calculate the correct transfer price, with no need to request any data from the non-Brazilian affiliate. Furthermore, in the case of exports, all necessary information can be accessed and verified by the Brazilian tax administration. As a result, the Cost Plus Method with fixed margins is typically applied for Brazilian export operations.

10.2.6.3. The Brazilian transfer pricing regulations establish that if the taxpayer finds a deviation of 5 per cent, or less, between the actual transfer price and parameter price calculated in accordance with the Brazilian transfer pricing legislation, the taxpayer is not requested to make any adjustment. Thus, in practice there is a range for each price.

10.2.7. Strengths and Weakness of the Brazilian Methods with Predetermined Profit Margins

10.2.7.1. The strengths of Brazil's predetermined profit margins when using the Resale Price Method and Cost Plus Method, which focus on simplicity, include:

- It avoids the need for specific comparables;
- The use of the conventional Resale Price Method and Cost Plus Method depends on the availability of certain data, databases or reports to empirically determine the gross profit margin and gross profit mark-up. In general, these elements are usually not easy to find;
- It frees scarce human resources and can be applied without technical knowledge of specific transfer price issues;
- It stabilizes the expectations of taxpayers with respect to their Brazilian tax liability associated with inter-company transactions;

- It is a low-cost system to companies and tax administration in that it does away with one aspect of a transfer pricing analysis, the need to empirically determine gross margins;
- It has an emphasis on practicality;
- It does not distort competition among enterprises located where the methodology is applied, since they are subject to the same tax burden, and they are not benefitting from asymmetry of information;
- It allows for simple implementation by tax authorities to audit taxpayers; and
- It is simple for taxpayers to apply it.

10.2.7.2. The weaknesses of Brazil's predetermined profit margins when using the Resale Price Method and Cost Plus Method include:

- The approach may lead to double taxation in case there is no access to competent authorities to negotiate relief of double taxation;
- The method requires clear classifications and accounting conformity with respect to the allocation of expenses between COGS and operating expenses;
- It is unavoidable that some Brazilian enterprises will be taxed at (higher or lower) profit margins not compatible with their profitability. This is because the fixed margin method applies regardless of the cost structures of taxpayers. For example, otherwise economically identical taxpayers with large COGS relative to operating costs will face higher tax burdens than taxpayers with low COGS relative to operating costs.

10.2.8. Other Explanations of the Brazilian Transfer Pricing Methodology

10.2.8.1. In case of import or export of commodities subject to trading in internationally recognized mercantile and futures exchanges, the method that should be used for imports is the Imports with Price under Quotation (PCI) Method, which is a simplified version of the Comparable Uncontrolled Price Method for imports, as defined in the law, and for exports is the Export with Price under Quotation (PECEX)

Method, which is a simplified version of the Comparable Uncontrolled Price Method for exports, as defined in the law. This mandatory methodology for such products considers the average quotation price of the global market as the arm's length price.

10.2.8.2. Brazilian transfer pricing legislation does not apply to cases of royalties and technical, scientific, administrative assistance or similar activities, which remain subject to the conditions for deductibility set out in the tax legislation.

10.2.8.3. There are also specific rules for loans in Brazil. According to the 2012 changes introduced by Provisional Measure n. 563/2012 (simplifying rules), interest paid or credited to a related person, due to the loan agreement, will only be deductible up to the amount not exceeding the calculated value based on the LIBOR rate (London Interbank Offered Rate) for deposits in US dollars for six months, plus 3 per cent margin as spread, pro-rated according to the period of the loan. Thus any amount exceeding this defined rate will not be accepted as deduction (the Ministry of Finance may adjust the 3 per cent margin, but only to make it lower).

10.2.9. Comments for Countries Considering the Adoption of Fixed Margins

10.2.9.1. Countries may establish different profit margins per economic sector, line of business or, even more specifically according to the kind of goods or services dealt with, to calculate the parameter price. The more accurately and the more margins are established, the more likely it is that the use of the margins will neither distort the system nor the decisions of the players involved.

10.2.9.2. It may not be possible to justify establishing many different margins, depending on the actual amount and types of goods and services exported and imported by a country. This is because it is possible that the country does not export or import a sufficiently large amount or many types of those goods and services and the determination of such margins, or even their applicability, could lead to some difficulties.

10.2.9.3. If a country opts for the application of different margins, these margins may be established at different levels of specificity. In

other words, such margins could be determined by economic sector (e.g. primary sector that is the extraction or production of raw materials, secondary sectors such as manufacturing and tertiary sectors such as services). A country may differentiate further, so that the margins could be determined by line of business at different levels of specificity according to the necessity and ability of a country to determine them. For example, the country could use a margin for the chemical industry as a whole, or different margins for different types of products of the chemical industry (agrochemical, petrochemical, explosives, cosmetics etc). The possibilities are nearly limitless. The differentiation per industry into types of products is adopted by Brazil, where, for the Resale Price Method for imports, the margin for chemicals sector in general is 30 per cent, while the margin for pharmaceutical chemicals and pharmaceuticals is 40 per cent. See Paragraph 10.2.1.3. above.

10.2.9.4. Each country should determine, according to its specific circumstances, the amounts involved and types of goods and services, how specific the margins should be and whether more margins are merited. Besides, a country may combine different levels of margin specifications if it seems appropriate; it may set forth some general margins for a line of business in addition to more specific margins for some goods.

10.2.9.5. In order to determine such fixed margins, the tax authorities will need to do pricing research, or purchase such information from existing (public) databases, in order to find appropriate prices that could be used as a comparable. Then, if it seems necessary to specify more profit margins, tax authorities will need to determine a range of profit margins, that is, a maximum and a minimum profit margin that statistically corresponds to relevant data of uncontrolled transactions. The maximum and minimum profit margin simply represents an acceptable divergence margin.

10.2.9.6. It is recommended that relevant taxpayers or groups that represent them verify the research, and that the margin found for that sector, line of business, good or service could be applicable to any, or the vast majority of transactions in that situation. In short, this method suggests that a margin that is used for similar sector, line of business or specific goods and services, can be used for similar situations.

10.2.9.7. It is important to emphasize that what will be applied, in practical terms, are not “margins” but “ranges”. As a result, what will be identified for a specific sector is an average. Thus, some companies may understand that they will fall below the average number, while others will fall above that number. For example, it is assumed that based on market research in a specific country the average market gross profit for resale transactions in the pharmaceutical sector is 30 per cent. It may well be the case that it is established that some companies have a 25 per cent margin and others a 38 per cent margin. Thus it would be advisable to have a range — in this case say 28 to 35 per cent — that is regarded as acceptable. The exact calculation of the range will depend on the distribution of the margins; in any case, the fixed margin should be inside the range. The details depend on the market, and if the range is very wide, that in itself indicates the need for further specification to line of products, or even to a specific product.

10.3. China Country Practice⁹⁸

10.3.1. Introduction — Bridging the Gap: Applying the Arm’s Length Principle in Developing Countries

10.3.1.1. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Transfer Pricing Guidelines) have been the “gold standard” for tax administrations and taxpayers to apply the “arm’s length principle” for the valuation, for tax purposes, of cross-border transactions between related parties for much of the period since the original version of the guidelines was first issued in 1995. As the world economy becomes increasingly globalized, transfer pricing is an issue faced not only by developed countries, but is increasingly a critical matter for developing countries. Such nations face a set of unique issues that have not been addressed, or at least not sufficiently or practically addressed by the OECD Guidelines. Therefore, while much of the OECD guidelines may still be applicable

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to developing countries, the UN Transfer Pricing Manual should put a special focus on offering practical solutions to issues faced by developing countries.

10.3.1.2. China started looking into transfer pricing issues in the late 1990s. While the early focus of transfer pricing investigations was mostly on tangible goods transactions, it has since been expanded into a range of other transactions, and in particular, those involving intangibles and services. As a developing country, China faces a number of difficult challenges, many of which remain unanswered by the OECD Guidelines. These include a lack of appropriate comparables, quantification and allocation of location-specific advantages, and identification and valuation of intangibles. The UN Transfer Pricing Manual must address these common issues for it to be useful to developing countries.

10.3.1.3. This paper intends to highlight some of the challenging issues faced by developing countries, and to share China's practical experience in dealing with these issues.

10.3.2. The Challenge of a Lack of Reliable Comparables

10.3.2.1. The “arm’s length principle” is at the core of the OECD Transfer Pricing Guidelines. Under this approach, transactions between group companies are compared with transactions between unrelated companies under comparable circumstances. Where there are no comparable transactions, then an alternative comparison may be made with unrelated companies that perform similar functions, own similar assets and bear similar risks to the taxpayer whose related party transactions are being examined, and operate under comparable circumstances.

10.3.2.2. Therein lies one of the key challenges for a developing countries—a lack of reliable, public information on comparables. For developing countries, there are usually only a small number of public companies, while information on domestic private companies is lacking or inadequate. This limits the amount of publicly available information on domestic companies that can be used for transfer pricing analysis. There would be, in particular, a lack of comparables for companies who are first-movers in an industry not yet fully exploited. In practice, foreign companies are often used as an alternative to

domestic comparables. As a result, comparables sets are often dominated by companies in developed countries, simply because there are usually a much larger number of public companies in these countries.

10.3.2.3. While globalization and free capital mobility are the basis for the use of foreign comparables, the existence of foreign exchange controls in many developing countries violates this pre-condition. Accordingly, significant comparability adjustments may be necessary for companies in developed countries to be used as comparables for companies in developing countries. In some cases, it may require a different methodology such as profit split as no sufficiently reliable comparability adjustment may be feasible.

10.3.2.4. One of the most common adjustments in China is accounting for differences in geographic comparability when applying profit-based transfer pricing methods, such as the Transactional Net Margin Method (TNMM), to determine an arm's length price. For example, when an Asia Pacific set of companies is used to benchmark the transfer prices of a Chinese taxpayer, as often being the case, it often includes companies from both developed countries (such as Japan and Korea), as well as developing countries (such as Indonesia and Vietnam). Generally speaking, the Asia Pacific set is more likely to contain companies from developed countries, due to a greater number of listed companies in those countries and hence there is a greater volume of publicly available financial information.

10.3.2.5. China takes the view that there may be instances where the differences in geographical markets are so material that it warrants comparability adjustments to bridge the differences. By making such comparability adjustments, taxpayers in developing countries can overcome the practical difficulties in applying the arm's length principle to their transfer pricing analysis.

10.3.3. Location-specific Advantages

10.3.3.1. The globalization of trade and economies has given rise to concepts such as "location savings", "market premium," and more generally, "location-specific advantages" (LSAs). LSAs are advantages for production arising from assets, resource endowments, government industry policies and incentives, etc, which exist in specific localities. For example, household electronics manufacturers invest in China to

take advantage of a large pool of well-educated low-cost labour and a well-developed network of suppliers. Likewise, global automotive companies set up joint ventures (JVs) in China to assemble automobiles locally to be close to the market and the customers and to take advantage of lower costs. Limited guidance is available on these concepts in the OECD Guidelines; it has been seen that certain issues such as location savings and market premium arise more frequently in China and other developing economies, rather than in established and developed economies (which comprise the bulk of the membership of the OECD). China outlines its solutions to reconcile the arm's length principle with the lack of reliable comparables in developing countries in the following paragraphs.

10.3.3.2. Location savings are the net cost savings derived by a multinational company when it sets up its operations in a low-cost jurisdiction. Net cost savings are commonly realized through lower expenditure on items such as raw materials, labour, rent, transportation and infrastructure even though additional expenses (so-called dis-savings) may be incurred due to the relocation, such as increased training costs in return for hiring less skilled labour.

10.3.3.3. Market premium relates to the additional profit derived by a multinational company by operating in a jurisdiction with unique qualities impacting on the sale and demand of a service or product.

10.3.3.4. In dealings with Chinese taxpayers, the Chinese tax administration has adopted a four step approach on the issue of LSAs:

1. Identify if an LSA exists;
2. Determine whether the LSA generates additional profit;
3. Quantify and measure the additional profits arising from the LSA; and
4. Determine the transfer pricing method to allocate the profits arising from the LSA.

10.3.3.5. In determining LSAs and their impact on transfer pricing, both industry analysis and quantitative analysis are critical.

10.3.3.6. The automotive industry is a good example where there are many LSAs that have led to extraordinarily high profits that are rightly earned by Chinese taxpayers. The LSAs here include:

- The “market-for-technology” industry policy, which requires foreign automotive manufacturers to form joint ventures (JVs) in order to assemble automobiles in China, forcing foreign automotive manufacturers to compete for limited market access opportunities by offering favourable terms including provision of technologies at below market price;
- Chinese consumers’ general preference for foreign brands and imported products—this general preference, as opposed to loyalty to a specific brand, creates opportunities for MNEs to charge higher prices and earn additional profits on automotive products sold in China;
- Huge, inelastic demand for automotive vehicles in China due to the large population and growing wealth of the population;
- Capacity constraints on the supply of domestically assembled automotive vehicles;
- Duty savings from the lower duty rates on automotive parts (e.g. 10 per cent) compared to imported vehicles (e.g. 25 per cent)—when MNEs manufacture products in China as opposed to importing the products from outside of China, they are able to generate overall savings from the lower duty rates, even if the MNEs incur manufacturing costs and sell their domestically-manufactured products at a lower sales price compared to a foreign-manufactured vehicle; and
- A large supply of high quality, low costs parts manufactured by suppliers in China.

10.3.3.7. For a 50/50 JV with partners having conflicting interests in the Chinese automotive industry, the Chinese JV partner generally contributes the local distribution network, intimate knowledge about the local market, and the right market access. However, the Chinese partner does not typically have control over the JV operation, which is usually controlled by the foreign JV partner. The foreign JV partner also controls the supply chain of the parts. To the extent there could still be potential transfer pricing issues, the primary issue involves the JV being overcharged for the parts and services that are provided by related parties. In the absence of such overcharging, the JV’s results

mainly reflect an arm's length outcome, which in turn reflect the contribution of LSAs to the JVs.

10.3.3.8. A further example is that of a Chinese taxpayer performing contract research and development (R&D) services for an offshore affiliate, and the full cost mark-up (FCMU) as the profit level indicator for a comparable set comprising of foreign companies located in developed countries (and hence, incurring higher costs). The following example outlines the steps used to calculate the adjusted FCMU taking into consideration the location savings.

10.3.3.9. It is assumed that the Chinese taxpayer's cost base was 100, the average cost base for the company's R&D centres in developed countries was 150, and the median FCMU of the comparables was 8 per cent. The comparison of the cost base between the Chinese taxpayer and that of the foreign companies is measured on an equal platform, such as the total costs (labour, raw materials, land and rent, etc) per unit of output.

	Steps	Calculations
1	Calculate the arm's length range of FCMUs based on foreign comparables, mostly in developed countries	Assume the median FCMU is 8%
2	Calculate the difference between the cost base of the Chinese taxpayer (e.g. 100) and the average cost base of the foreign companies (e.g. 150)	$150 - 100 = 50$
3	Multiply the arm's length FCMU (e.g. 8 per cent) with the difference in the cost bases (50)	$0.08 \times 50 = 4$
4	The resulting profit is the additional profit (i.e. 4) attributable to China for location savings	4
5	Determine the total arm's length profit for the Chinese taxpayer	$4 + 0.08 \times 100 = 12$
6	Determine the adjusted arm's length FCMU for the Chinese taxpayer	$12/100 = 12\%$

10.3.3.10. The Chinese tax administration has come across many other cases of market premiums for Chinese taxpayers, particularly in the luxury goods sector.

10.3.4. Intangibles

10.3.4.1. Intangibles are as major an issue for developing countries as they are for developed countries. While MNEs in developed countries often have superior technology intangibles, they need the fast growing market in the developing countries and contribution of the subsidiaries in these countries to develop these markets in order to monetize the value in such intangibles. For developing countries, marketing intangibles and LSAs are often closely integrated, and due consideration is necessary to properly compensate the contribution of the subsidiaries in developing countries.

10.3.4.2. MNEs often provide intangibles to their Chinese affiliates in the initial stages of the local operation to help establish the business in China. These intangibles may take various forms, such as a global brand name, technical know-how or business processes. Over time, the local Chinese affiliates acquire the skill and experience from operations in China, and may even contribute to the improvement of the MNE's original intangibles. The issue in this scenario is whether the local Chinese affiliates should be entitled to additional profit, and if so, what is the appropriate method to calculate the additional profit?

10.3.4.3. For example, if a Chinese affiliate was charged a 3 per cent royalty for the use of a manufacturing process when the Chinese operations were established ten years ago in 2002, then it may not be reasonable for the Chinese affiliate to continue paying the same royalty in 2012 without revisiting whether the intangible has continued to provide the same value over time. This is particularly the case if the Chinese affiliate has improved upon the manufacturing process provided by its parent company, through a process of trial and error and conducting manufacturing operations over a ten year period. We would question whether the Chinese affiliate should continue to pay a royalty to the parent company for the manufacturing process, or whether the Chinese affiliates should be entitled to a return on the intangibles that they have developed and shared with the group companies.

10.3.5. Practical Issues and Solutions

10.3.5.1. In a globalizing economy, MNEs usually set up operations in developing countries to take advantage of comparative advantages

that these countries offer. For example, they set up manufacturing operations to take advantage of the abundant cheap labour or natural resources to supply products for overseas markets, R&D to take advantage of local talent for overseas principals, and distribution of imported products to the local market. These operations often take the form of contract or toll manufacturing, contract R&D, and limited risk distribution to leave little profit to the local country, despite the fact that many such comparative advantages contribute significant profits to the multinational group. The following paragraphs share some of the Chinese experience in dealing with these transfer pricing issues.

10.3.5.2. A holistic view of functions and risks may need to be taken. Many MNEs have set up multiple companies in China with each company performing only a single function, such as manufacturing, distribution, R&D, and services, and with the claim that each of these entities is entitled to a limited return. Others have some or all of manufacturing, distribution, R&D, and services functions in one entity, and still claim that each of these functions is entitled to only a routine return. The Chinese tax administration takes the view that when a group has multiple single function entities, they may have to be taken into consideration as a whole in order to properly determine the return the group companies should earn in China. Similarly, an entity with multiple functions may have to be reviewed in its entirety in order to properly determine its returns.

10.3.5.3. While China generally respects the limited risk characterization of sole function entities;⁹⁹ determining an adequate return for such entities is a challenge, as explained below. Further, China has legislated a specific article in its transfer pricing rules to require that such entities should not bear risks or suffer from losses arising from strategic failures, capacity under-utilization, or hold-up in the sales of products, etc, if they do not perform business strategy decision making, product R&D, or sales functions. Simply put, if their upside is limited, their downside should be limited too.

10.3.5.4. Contract R&D is an area where the contribution of developing countries is often underestimated. The transfer pricing method commonly used to reward R&D activities performed by a subsidiary

⁹⁹For example toll or contract manufacturing, limited risk distribution, or limited risk service provider.

of an MNE in China is the Cost Plus Method. Sometimes, it has been found that the principal entity that is claimed to be responsible for the R&D has neither the technical expertise nor the financial capacity to be responsible. In other instances, the Chinese entity has obtained “high and new technology status” in Chinese law and therefore enjoys tax incentives on the basis of ownership of valuable core technology on the one hand. However, it also claims to be a contract R&D service provider with no valuable intangibles on the other hand. These are only a few examples where a cost plus approach would not be adequate, and a different method such as Profit Split Method would be more appropriate. It is expected that companies claiming high tech status should be performing activities that result in the creation of intellectual property of which they can claim economic or legal ownership. It is not sufficient by itself that the contract R&D entity has shifted the majority of its risks (e.g. unsuccessful research) to its entrepreneurial related party. A proper analysis of the value provided by the contract R&D entity to the overall group operations should be conducted to determine the appropriate arm’s length return for the R&D entity.

10.3.5.5. Contract manufacturing is one of the most common forms of manufacturing used by MNEs in China, particularly dealing with manufacturing products for export. In evaluating a contract manufacturer’s return, the TNMM is often used as the transfer pricing method with the FCMU being the most commonly used profit level indicator.

10.3.5.6. The arm’s length principle involves testing controlled transactions with uncontrolled transactions to determine how independent parties would have acted in broadly comparable situations. This principle becomes challenging to apply where a company relies on its related parties for both input purchase and output sales. If such a company is to be evaluated on a cost plus basis, a low inter-company purchase price results in an undervalued cost base that will ultimately under-compensate the contract manufacturer. However, the reasonableness of the purchase price is often difficult to assess. A further issue therefore arises as to how the reasonableness of a taxpayer’s inter-company arrangements in this situation should be evaluated.

10.3.5.7. The Chinese approach to evaluating such companies is to start with the general presumption that the related party purchase price of materials is at arm’s length, and evaluate the reasonableness of the mark-up earned by the contract manufacturer on its cost base.

The rationale for accepting the related party purchase price is that the customs administration can act as a check on the reasonableness of the import price of materials and safeguard against unreasonably low inter-company purchase prices. The next step is to proceed with the transfer pricing analysis by adopting a cost plus methodology and using the FCMU as the profit level indicator. The challenge that follows lies in the search for suitable comparable companies, as discussed earlier in this paper.

10.3.5.8. Toll manufacturing is a common form used by MNEs in developing countries, but its proper return is difficult to determine since there are only a few independent listed companies that perform such activities. Some taxpayers simply use the FCMU for contract manufacturers as the mark-up for toll manufacturers. This grossly underestimates the return to toll manufacturers. Others use return on assets as a profit level indicator, using contract manufacturers as comparables, and this may also underestimate the return, particularly for toll manufacturers that are highly labour intensive, as is often the case in developing countries.

10.3.5.9. In practice, the Chinese tax administration has sought to first estimate the total cost of the toll manufacturing operation as if it were a contract manufacturer, usually by adding back the costs of raw materials which may be obtained from the customs administration. It then estimates the appropriate returns (say, FCMU) for contract manufacturing based on contract manufacturing comparables, and applies this to the estimated total cost to arrive at the total contract manufacturing profit, from which it then adjusts for factors such as inventory carrying costs, to arrive at the total profit for the toll manufacturer. This approach works well when reliable customs information on raw materials exists. In cases where customs information on raw materials is not available or not reliable, however, there are unresolved issues as to what should be an appropriate profit level indicator and how it could be derived.

10.3.5.10. Sales, marketing and distribution are another set of functions where MNEs often underestimate the contribution of developing countries. Chinese experience shows that many MNEs treat their Chinese distribution entities as a limited risk distributor, and use a set of simple distributors performing limited functions in a mature market such as Japan as the comparables. There are a couple of obvious

deficiencies in such an approach. Firstly, there is often a mismatch in terms of functional profile, as the Chinese entity may perform significantly more functions than these so-called comparables, which is evident as the Chinese businesses incur significantly more operating expenses relative to sales. Second, it does not account for differences in market differences, with China being a fast-growing economy and having strong demand which requires relatively less selling effort and therefore can achieve higher efficiency and profitability. Other location-specific advantages such as country premium and any marketing intangibles that are created by the Chinese entity are also commonly ignored.

10.3.5.11. In practice, the Chinese tax administration has attempted to correct such deficiencies by using a more appropriate transfer pricing method, such as the Profit Split Method in the cases where the administration identifies significant local marketing intangibles or LSAs. Alternatively, the Chinese tax administration performs comparability adjustments when TNMM is used. For example, if the median operating expense to sales ratio for the comparable set is only 7 per cent, and the same ratio for the taxpayer is 40 per cent. To the extent that there are location savings, cost base is adjusted first. The Chinese tax administration would then calculate the additional return required for the extra efforts made by the Chinese taxpayer to derive the total return for the Chinese taxpayer.

10.3.6. Alternative Methods to the Traditional Transactional Net Margin Method

10.3.6.1. While the TNMM may still be used when there is a lack of adequate local comparables, such as using foreign comparables with proper adjustments, as in the contract R&D example, sometimes a different method such as the Profit Split Method may be more appropriate. An example is the electronic manufacturing services (EMS) sector, where the entire, or nearly the whole manufacturing and assembly activities of a foreign EMS multinational group, have been outsourced to its Chinese affiliate.

10.3.6.2. The typical set up for these manufacturing and assembly operations is such that the majority of the work force and tangible

assets of these foreign EMS multinational groups are located in China, including many high-level operational staff. The headquarters of these EMS companies are located outside of China, with the EMS group's revenues supported by significant manufacturing contracts with third party global consumer electronics companies. Often, in such instances, the multinational group's transfer pricing policies have little regard for properly compensating the Chinese manufacturer. The profits of the Chinese manufacturer are stripped away as much as possible on the basis that the manufacturer is a contract manufacturer or a toll manufacturer with a very low risk profile.

10.3.6.3. Under this scenario, China takes the view that a risk-based approach may have insufficient regard for the fact that there are sizeable assets located in China (i.e. the work force and factory plants). In many cases, the majority of the headcount of the EMS group are based in China, with only a few management personnel residing outside of China. Rather than a transactional or profits-based approach, a contribution analysis approach may be more suitable. This means that remuneration to each party involved would be commensurate with its role and contribution to the value chain in the group. In this case, the assets and the people should largely dictate where the group's profits should stay, and a global formulary approach should be a realistic and appropriate option.

10.3.6.4. Alternatively, the Chinese tax administration may determine the property return for the headquarters, with the Chinese manufacturer earning the residual profits. Another potential alternative may be to evaluate the Chinese manufacturer on the return on its assets or capital employed, using the group's results as a comparable for the Chinese manufacturer.

10.3.7. Other Experience and Recommendations

10.3.7.1. One of the key issues faced by developing countries is the lack of experience and knowledge on how MNEs operate and on the characteristics of particular industries. Transfer pricing is commonly acknowledged as one of the most difficult international tax issues, and MNEs as well as tax administrations in developed countries have built up and dedicated substantial resources including human resources to

this area. The Chinese experience has been that a dedicated team, with backgrounds in accounting, economics and industry understanding would be very critical, in order for tax administrations in developing countries to effectively administer transfer pricing rules.

10.3.7.2. Issues such as LSAs further raise the stakes. To effectively deal with such issues, solid economic and quantitative analyses are necessary. Compared with MNEs, which have vast resources at their disposal to hire the best professionals, and with tax administrations in developed countries which also have developed a large team of economists and quantitative analysts, developing countries such as China have a clear disadvantage, which has to be remedied urgently. China currently has more than 200 officials dedicated to transfer pricing issues, and aims to increase this number to 500 specialists over the next two to three years. This will include a specialist panel to review substantial cases such as national transfer pricing audits. This panel review system, together with the centralized approval system on transfer pricing audit cases and national information system, will ensure that Chinese transfer pricing investigations are carried out consistently and with a high level of quality.

10.3.7.3. One way to address the disadvantages faced by developing countries in transfer pricing administration is to expand the statute of limitations. For example, the statute of limitations for corporate income tax is normally five years in China. However, the statute of limitation for transfer pricing has been extended to ten years, allowing more time for tax administration to examine taxpayers' transfer pricing issues. Another way is to set clear compliance and penalty rules, putting the burden of proof on taxpayers and encouraging taxpayers to be in compliance and to make self-adjustments when needed. It has been found that contemporaneous documentation requirements coupled with penalty rules have been very effective in encouraging taxpayer compliance. An industry-wide or a multinational group-wide audit has also been a very effective and efficient way for the tax administration to best make use of its limited resources.

10.3.7.4. As an emerging market economy, China's priority is to establish a robust system that is based on a balanced approach with three pillars—administration, service, and investigation. Administration includes having the right policies in place, including

avoiding loopholes and having effective disclosure requirements. The Service pillar includes reducing the effort and resources businesses have to employ to show their tax compliance. The Advance Pricing Arrangement Programme, for example, exemplifies this focus. For investigation, China does not always have the same technical expertise and resources that developed countries possess. Nevertheless, transfer pricing work in China is developing quickly. The real objective in conducting audits is to raise awareness of the Chinese determination to enforce tax compliance, and the tax administration, the third pillar, has been using an industry based approach to accomplish this. As a testament to its success, the average profit margin in one of the industries focused on has increased from less than 1 to 5.6 per cent between 2004 and 2008.

10.3.8. Conclusion

10.3.8.1. Application of the arm's length principle to MNEs operating in developing countries poses a practical challenge. Once developing countries overcome the issues involved in establishing a sound legal framework for transfer pricing, they often encounter the issue of a lack of sufficient transfer pricing specialists to carry out the analysis, and a lack of reliable comparables for the analysis itself.

10.3.8.2. China, as a developing country, has unique economic and geographic factors which contribute to the profitability of Chinese taxpayers and their foreign parent companies. These factors include, but are not limited to, readily available migrant labour, low labour and infrastructure costs, first-mover advantages in certain industries, foreign exchange controls, growing population and consumer demand for foreign and luxury products. Other developing countries have their own unique features that similarly require special attention from a transfer pricing perspective.

10.3.8.3. In China's experience, MNEs have often implemented group transfer pricing policies that are sensitive to developed countries' transfer pricing regulations and nuances, but neglect to consider whether the arm's length principle has been applied properly in developing countries.

10.3.8.4. China has overcome this challenge by using some practical solutions that are sensitive to unique economic and geographic factors

for companies operating in China. These solutions include concepts such as location savings, market premium and alternative methods of analysis besides the traditional transactional and profit-based methods.

10.3.8.5. The Chinese tax administration has shared its insights on applying the arm's length principle for developing countries, and welcomes other perspectives on these issues.

10.4. Emerging Transfer Pricing Challenges in India

10.4.1. Transfer Pricing Regulations in India

10.4.1.1. The Indian Transfer Pricing Regulations are based on the arm's length principle. The regulations came into effect from 1 April 2001. The regulations provide that any income arising from an international transaction between associated enterprises shall be computed having regard to the arm's length price (ALP). The concept of associated enterprises has been defined in detail in the regulations.

10.4.1.2. The ALP shall be determined by any of the prescribed methods. The methods prescribed for the determination of arm's length price are the: Comparable Uncontrolled Price Method, Resale Price Method, Cost Plus Method, Transactional Net Margin Method, the Profit Split Method and a residual method known as "any other method" appropriate to determine the arm's length price under the statute. The regulations do not provide any hierarchy of the methods and support the concept of the "most appropriate method" which provides the most reliable measure of an arm's length result under a particular set of facts and circumstances.

10.4.1.3. The regulations prescribe mandatory annual filing requirements as well as maintenance of contemporaneous documentation by the taxpayer in case international transactions between associated enterprises cross a threshold and contain stringent penalty implications in case of non-compliance. The primary onus of proving the arm's length price of the transaction lies with the taxpayer. The Indian transfer pricing administration prefers Indian comparables in most cases and also accepts foreign comparables in cases where the foreign associated enterprise is the less or least complex entity and requisite information is available about the tested party and comparables.

10.4.1.4. In order to provide uniformity in application of transfer pricing law there is a specialized Directorate of Transfer Pricing to administer transfer pricing rules under the supervision of the Director General of Income Tax (International Taxation). Transfer Pricing Officers (TPO) are vested with powers of inspection, discovery, enforcing attendance, examining a person under oath, on-the-spot enquiry/verification and compelling the production of books of account and other relevant documents during the course of a transfer pricing audit. A dispute resolution panel (in short DRP) is available to taxpayers to resolve disputes relating to transfer pricing before disputes over a final written order by an Assessing Officer (which incorporates the written order of the TPO).

10.4.2. Key Current and Emerging Transfer Pricing Audit Issues in India

Over the past ten years, the Indian transfer pricing administration has witnessed several challenges in the administration of transfer pricing law. Against the backdrop noted above, this chapter highlights some of the emerging transfer pricing issues and difficulties in implementation of the arm's length principle.

10.4.3. Challenges in the Comparability Analysis

10.4.3.1. Generally speaking, the Indian tax administration believes that comparability analysis is key to determine the arm's length price of international transactions. However, increased market volatility and increased complexity in international transaction have thrown open serious challenges to comparability analysis and determination of an arm's length price. Some of these challenges and the responses of Indian transfer pricing administration in dealing with these challenges have been analysed below.

10.4.3.2. Use of contemporaneous data: Commodity price volatility, large public debt, recession and other economic concerns have brought volatility to world market. Such volatility impedes a stable business environment and results in the fluctuation of margins for MNEs and their subsidiaries. In this context, use of contemporaneous comparables provides a more accurate arm's length price in a particular year.

10.4.3.3. Application of data rules: The Indian transfer pricing regulations stipulate that data to be used in analyzing the comparability of uncontrolled transaction with an international transaction should be the data relating to the financial year in which international transactions have been entered into. However, the rule also provides exception and permits the use of data for the preceding two years if and only if, it is proved that such data reveals a fact which could have an influence on the determination of the arm's length price. Therefore, the exception comes into play only when a proof that earlier year data could have an influence on determination of the arm's length price is provided.

10.4.3.4. Rationale: The mandatory requirement under the law to use contemporaneous document has a solid economic sense in the way that contemporaneous transaction reflect similar economic conditions. Therefore, use of current year data is more relevant and appropriate for ensuring a higher degree of comparability of uncontrolled transactions for arriving at the arm's length price in respect of an international transaction. In India, contemporaneous data which may be available to the taxpayer and tax administration at the time of filing of the tax return or conducting ex post facto analysis of transfer pricing studies cannot be held as use of hindsight.

10.4.4. Issue Relating to Risks

10.4.4.1. A comparison of functions performed, assets employed and risks assumed is the basis of any comparability analysis. India believes that the risk of an MNE is a by-product of its performance of functions and ownership and the exploitation or use of assets employed over a period of time. Accordingly, risk is not an independent element but is similar in nature to functions and assets. In this context, India believes that it is unfair to give undue importance to risk in determination of arm's length price in comparison to functions performed and assets employed.

10.4.4.2. Identification of risk and of the party which bears such risks are important steps in comparability analysis. India believes that the conduct of the parties is key to determining whether the actual allocation of risk conforms to contractual risk allocation. Allocation of risk depends upon the ability of parties to the transaction to exercise

control over such risk. Core functions, key responsibilities, key decision-making and levels of individual responsibility for the key decisions are important factors to identify the party which has control over the risks.

10.4.4.3. In India, MNEs are making claims before the transfer pricing auditor that related parties engaged in contract R&D or other contract services in India are risk-free entities. Accordingly, these related parties are said to be entitled to only routine (low) cost plus remuneration. MNEs also contend that the risks of R&D activities or services are being controlled by them and Indian entities being risk-free entities are only entitled to low cost plus remuneration.

10.4.4.4. The Indian transfer pricing administration does not agree with the notion that risk can be controlled remotely by the parent company and that the Indian subsidiaries or related party engaged in core functions, such as carrying out research and development activities or providing services are risk free entities. India believes that core function of R&D or services are located in India which in turn require important strategic decisions by management and employees of Indian subsidiaries or related party in terms of design, the direction of R&D activities or providing services and monitoring of R&D activities etc. Accordingly, the Indian subsidiary exercises control over the operational and other risks. In these circumstances, the ability of the parent company to exercise control over the risk — remotely and from a place where core functions of R&D and services are not located — is very limited. In these circumstances, allocation of risk to the parent MNE is not only questionable but is devoid of logical conclusion.

10.4.4.5. India believes that, in the circumstances mentioned at 10.4.4.3 above, the subsidiary carries out core functions and by taking strategic operational decisions controls a substantial part of the risk. India believes that the parent company should be entitled to appropriate returns for provision of funds and overall direction to R&D activity or services. The Indian subsidiary should also be entitled to returns on their core function including strategic decisions and control on risk related to the operation of R&D activities. In this context, the Indian tax administration is of the view that allocation of routine and low cost plus return in these cases will not reflect a true arm's length price of the transaction.

10.4.5. Arm's Length Range

Application of the most appropriate method may set up comparable data which may result in computation of more than one arm's length price. Where there may be more than one arm's length price, the Indian transfer pricing regulations provide that in such a case the arithmetic mean of the prices should be adopted as the arm's length price. If the variation between the arithmetic mean of uncontrolled prices and the pricing of the international transaction under review does not exceed 3 per cent or other notified percentage of such transfer pricing, then transfer price will be considered to be at arm's length. In case a transfer price crosses the tolerance limit, the adjustment is made from the central point determined on the basis of the arithmetic mean. Indian transfer pricing regulations do not mandate use of the interquartile range.

10.4.6. Comparability Adjustment

10.4.6.1. As with many other countries, Indian transfer pricing regulations require for "reasonably accurate comparability adjustments". The onus to prove "reasonably accurate comparability adjustment" is on the taxpayer. The experience of the Indian transfer pricing administration indicates that it is possible to address the issue of accounting and capacity utilization differences as well as different intensities of working capital by making comparability adjustments. However, the Indian transfer pricing administration finds it extremely difficult to make risk adjustments in the absence of any reliable and robust and internationally agreed methodology to provide risk adjustment. In some cases taxpayers have used the Capital Asset Pricing Model (CAPM). However, the methodology was found flawed for the reasons outlined in the following paragraphs.

10.4.6.2. The CAPM assumes that the rates of return of most assets within a portfolio are normally distributed (meaning rates of return do not deviate too much from the mean). However, historically speaking, equities have been prone to large deviations from the mean much more frequently than it is generally assumed under the CAPM. So, if an asset is actually prone to large swings in either direction from its mean, then it stands to reason that its risk aspect may not be correctly captured by the CAPM calculation.

10.4.6.3. The CAPM is not able to capture all variations in equity returns in the same industry segment. Past empirical studies have demonstrated that some stocks, although they had lower beta (lower volatility in relation to the market) and implied lower risk versus return ratios, still managed to achieve higher returns than the CAPM would have assumed initially.

10.4.6.4. On a more practical level, one of the shortfalls of the CAPM is that the model assumes all investors have the same concept of what constitutes risk and required rates of return, as well as the fact that the model excludes the impact of taxes and transaction costs which, in reality, have adverse effects on the expected rate of return.

10.4.6.5. The CAPM assumes the application of the market portfolio, which is supposed to consist of all risky assets in all markets. The CAPM also assumes that investors have no individual preference as to which risky assets they wish to invest in and in which markets. Yet, investors have been known to depart from assets risk versus return profiles often, and particularly at times when markets were not normally distributed.

10.4.6.6. The CAPM accepts the concepts of the market portfolio, which theorizes inclusion of literally all asset classes, including real estate, art, intellectual property etc. However, in reality such a market portfolio is impossible to construct which is why it is often equated with various composites. However, limiting the market portfolio in such a manner could (and indeed has) resulted in inaccuracies within the CAPM, thus rendering it at the very least empirically inconsistent.

10.4.6.7. An important flaw relating to the computation of risk adjustment by the taxpayer is the use of the “beta” concept. It is important to remember that computation of beta is based on a presumption that high-beta shares usually give the highest returns. Over a long period of time, however, high beta shares are the worst performers as their share price depress dramatically during market declines (i.e., in a “bear market” which is historically a more common phenomena in the Indian stock exchange). While someone might receive high returns from high beta shares, there is no guarantee that the CAPM return is realized. It is worthwhile to mention here that the computation of beta in this case is based on the seven year average price of comparables and tested party

shares. The methodology of taking an average of such a long period is highly questionable in existing volatile world market conditions.

10.4.6.8. The Indian tax administration has also experienced difficulties in obtaining reliable data for the computation of comparability adjustments such as capacity and working capital adjustments, however, the methodology to determine comparability adjustments is more or less internationally agreed.

10.4.7 Location Savings

10.4.7.1. It is the view of the Indian transfer pricing administration that the concept of “location savings” — which refer to cost savings in a low-cost jurisdiction such as India — should be one of the major aspects to be considered while carrying out comparability analysis during transfer pricing audits. Location savings has a much broader meaning; it goes beyond the issue of relocating a business from a “high-cost“ to a ”low-cost” location and relates to any cost advantage. MNEs continuously search for options to lower their costs in order to increase profits. In this respect, India provides operational advantages to the MNEs such as labour or skill employee cost, raw material cost, transaction costs, rent, training cost, infrastructure cost, tax incentive etc.

10.4.7.2. It has also been noticed that India provides the following Location-Specific Advantages (LSAs) to MNEs in addition to location savings:

- Highly specialized and skilled manpower and knowledge;
- Access and proximity to growing local/regional markets;
- Large customer base with increased spending capacity;
- Superior information networks;
- Superior distribution networks;
- Incentives; and
- Market premium.

10.4.7.3. The incremental profit from LSAs is known as “location rents”. The main issue in transfer pricing is the quantification and

allocation of location savings and location rents among the associated enterprises. Using an arm's length pricing approach, the allocation of location savings and rents between associated enterprises should be made by reference to what independent parties would have agreed in comparable circumstances. The Indian transfer pricing administration believes it is possible to use the Profit Split Method to determine arm's length allocation of location savings and rents in cases where comparable uncontrolled transactions are not available. In these circumstances, it is considered that the functional analysis of the parties to the transaction (functions performed, assets owned and risks assumed), *and* the bargaining power of the parties (which at arm's length would be determined by the competitiveness of the market — availability of substitutes, cost structure etc) should both be considered appropriate factors.

10.4.7.4. Comparability analysis and benchmarking by taking local comparables will determine the price of a transaction with a related party in a low-cost jurisdiction. However, it will not take into account the benefit of location savings which can be computed by taking into account the cost difference between costs in the low-cost country and in the high-cost country from where the business activity was relocated. In view of this, the price determined on the basis of local comparables is not consistent with the arm's length price because any arm's length transaction between two unrelated parties would not be possible without benefiting both parties to the transaction.

10.4.7.5. Hypothetically, if an unrelated third party had to compensate another party to the transaction in a low-cost jurisdiction by an amount that was equal to the cost savings and location rents attributable to the location, there would be no incentive for the unrelated third party to relocate business to a low-cost jurisdiction. Thus, the arm's length compensation for cost savings and location rents should be such that both parties would benefit from participating in the transaction. In other words, it should not be less than zero and yet not greater than the value of cost savings and locations rents combined. Moreover, it should also reflect an appropriate split of the cost savings and location rents between the parties.

10.4.8. Intangibles

General

10.4.8.1. Transfer pricing of intangibles is well known as a difficult area of taxation practice. The pace of growth of the intangible economy has opened new challenges to the arm's length principle. 75 per cent of all private R&D expenditure worldwide is accounted for by MNEs. World royalty and license fee receipts that were just US\$29 Billion in the year 1990 has increased to US \$191 Billion in 2010.

10.4.8.2. Transactions involving intangible assets are difficult to evaluate because of the following reasons:

- Intangibles are rarely traded in the external market and it is very difficult to find comparables in the public domain;
- Intangibles are often transferred bundled along with tangible assets; and
- They may be difficult to detect.

10.4.8.3. A number of difficulties arise while dealing with intangibles. Some of the key issues revolve around determination of the arm's length price of rate of royalties, allocation of cost of development of market and brand in a new country, remuneration for development of marketing, R&D intangibles and their use, transfer pricing of co-branding etc. Some of the Indian experiences in this regard are discussed below.

10.4.8.4. With regard to payment of royalties, MNEs often enter into agreements allowing use of brands, trademarks, know-how, design, technology etc by their subsidiaries or related parties in India. Such payments can be in a lump sum, periodical payments or a combination of both types of payments. It is an internationally agreed position that intellectual property, which is owned by one entity and used by another entity, generally requires a royalty payment as consideration for the use. However, the important issue in this regard is the determination of the rate of royalty. The main challenge in determining the arm's length royalty rate is to find comparables in the public domain with sufficient information of the type required for comparability analysis. The Indian experience suggests that it is impossible to find

comparable arm's length prices in most cases. The use of the Profit Split Method as an alternative is generally not a feasible option due to the lack of requisite information.

10.4.8.5. The Indian tax administration has noticed serious difficulties in determining the rate of royalty charged for the use of brands and trademarks in certain cases. In some cases the user had borne significant costs in promoting the brand/trademark, and to promote and develop customer loyalty for the brand/trademark in a new market. In these cases, the royalty rate charged by the MNE will depend upon the cost borne by the subsidiary or related party to promote the brand and trademark and to develop customer loyalty for that brand and product. In many cases no royalty may be charged by, for example, the local subsidiary in the uncontrolled environment and the subsidiary would require arm's length compensation for economic ownership of marketing intangible developed by it and for enhancing the value of the brand and trademark owned by parent MNEs in an emerging market such as India.

10.4.8.6. In many cases, Indian subsidiaries using the technical know-how of their parent company have incurred significant expenditure to customize such know-how and to enhance its value by their R&D efforts. Costs of activities, such as R&D activities which have contributed in enhancing the value of the know-how owned by the parent company, are generally considered by the Indian transfer pricing officer while determining the arm's length price of royalties for the use of technical know-how.

10.4.8.7. The Indian transfer pricing administration has also noted significant transfer pricing issues in cases of co-branding of a new foreign brand owned by the parent MNE (a brand which is unknown to a new market such as India) with a popular Indian brand name. Since the Indian subsidiary has developed valuable Indian brands in the domestic market over a period of time, incurring very large expenditure on advertisement, marketing and sales promotion, it should be entitled to arm's length remuneration for contributing to increasing the value of the little known foreign brand through co-branding it with a popular Indian brand and therefore increasing market recognition.

R&D activities

10.4.8.8. Several global MNEs have established subsidiaries in India for research and development activities on a contract basis to take advantage of the large pool of skilled manpower which are available at a lower cost. These Indian subsidiaries are generally compensated on the basis of routine and low cost plus mark-up. The parent MNE of these R&D centres justify low cost plus mark-up on the ground that they control all the risk and their subsidiaries or related parties are risk free or limited risk bearing entities. The claim of the parent MNEs that they control the risk and are entitled to a major part of profit from R&D activities is typically based on the contention that they:

- Design and monitor all the research programmes of the subsidiary;
- Provide the funds needed for the R&D activities;
- Control the annual budget of the subsidiary for R&D activities;
- Control and take all the strategic decisions regarding the core functions of R&D activities of the subsidiary; and
- Bear the risk of unsuccessful R&D activities.

10.4.8.9. The Indian transfer pricing administration always undertakes a detailed enquiry in cases of contract R&D centres. Such an enquiry seeks to ascertain the correctness of the functional profile of the subsidiary and parent MNE on the basis of transfer pricing reports filed by the taxpayers, as well as information available in the public domain and commercial databases. After conducting detailed enquiries, the Indian tax administration have often reached the following conclusions:

- Most parent MNEs were not able to file relevant documents to justify their claim of controlling the risk of core functions of R&D activities and assets (including intangible assets) which are located in the country of the subsidiary or related party;
- Contrary to the above claims, it was found that day-to-day strategic decisions and monitoring of R&D activities were carried out by personnel of the subsidiary who were engaged in actual R&D activities and bore relevant operational risks;

- The management of the Indian subsidiary also took decisions concerning the allocation of budget to different streams of R&D activities and Indian management also monitored the day-to-day performance of R&D activities; and
- It was true that in most of the cases funds for R&D activities were transferred from the MNE parent and they bore the risk of such fund. However, in addition to “capital” other important assets such as technically skilled manpower, know-how for R&D activities etc were developed and owned by the Indian subsidiary. Accordingly, control of risk of the asset lay both with the MNE parent and Indian subsidiary but the Indian subsidiary controlled more risks as compared to the MNE parent.

10.4.8.10. On the basis of the above functional analysis, the Indian transfer pricing administration decided in most of the cases that Indian subsidiaries were not risk-free entities but to the contrary bore economically significant risk. Accordingly, Indian subsidiaries were entitled to an appropriate return for their function including the strategic decision, monitoring, use of their assets and control over the risk. In view of these facts, the routine and low cost plus compensation model could not arrive at an arm’s length price.

10.4.8.11. Most of these R&D centres in India were actually found to be engaged in the creation of unique intangibles, legal ownership of which was transferred to their parent MNEs under agreement. Such transfer took place without any appropriate compensation and patents for these intangibles were registered in the name of the parent MNE. In these cases the Indian transfer pricing administration allocated additional arm’s length compensation for transfer of such intangibles in addition to arm’s length compensation for R&D activities.

Marketing intangibles

10.4.8.12. Transfer pricing aspect of marketing intangibles has been a focus area for the Indian transfer pricing administration. The issue is particularly relevant to India due to its unique market specific characteristics such as location advantages, market accessibility, large customer base, market premium, spending power of Indian customers etc. The Indian market has witnessed substantial marketing activities by

the subsidiaries and related parties of MNE groups in the recent past, which have resulted in the creation of local marketing intangibles.

10.4.8.13. For the Indian transfer pricing administration a first important step is to identify marketing intangibles. Marketing intangibles are generally identified on the basis of the efforts of the Indian subsidiary/related party towards:

- Enhancing the value of the foreign trademark or brand that is unknown to Indian market by incurring very large advertisement, marketing and sale promotion expenditures;
- Creation of brand and product loyalty in the minds of customers;
- Creation of an efficient supply chain;
- Establishing distributor networks in the country;
- Developing an after sale services and support network in the country;
- Conducting customer and market research; and
- Gathering customer data and establishing customer lists, etc.

10.4.8.14. Indian subsidiaries or related parties (which are claimed as no risk and limited risk bearing distributors by the parent MNE in order to justify low cost plus return) have incurred and borne very large expenditures on the development of marketing intangibles. These entities therefore generally incur very large losses or disclose very nominal profit as evident from their return of income.

10.4.8.15. Determination of an arm's length price in cases of marketing intangibles generally involves the following steps:

- Functional analysis of the profile of the Indian entity and the parent MNE to ascertain whether the Indian entity is a risk-free, limited risk bearing or risk bearing entity;
- Identification of the nature, types and stages of development of marketing intangibles. The Indian entity may be engaged in different stages of development of marketing intangibles. For example if an MNE is a new entrant into the Indian market, the related party in India will incur substantial expenditures to create:

- awareness about the trademark, brand and product or services of MNE group in India;
- customer loyalty for the brand and relevant products and/or services;
- a dealer network;
- an after sale services and support network;
- market and customer research; and
- customer data and lists.

After some years of operation, the cost of developing and sustaining marketing intangibles may be reduced;

- Identification of expenditures due to the launch of new products in India and ascertaining who has borne such expenditure;
- Ascertaining who has borne the cost of development of marketing intangibles; and
- Examination of the remuneration model to the Indian related party.

10.4.8.16. The Indian tax administration computes the ALP in the cases involving marketing intangibles following the concept of a “bright line” test; that is, no risk or limited risk distributor will bear the cost of only routine expenditure on advertisement, marketing and sale promotion (AMP). However, the tax administration faces the following challenges in determination of the ALP:

- The issue of whether the parent MNE should reimburse the cost incurred by the Indian subsidiary or related party for the development of marketing intangibles with or without mark-up;
- Lack of uniform accounting rules creates significant difficulties in identifying AMP expenditure in comparable companies and the tested party; and
- The developer of marketing intangibles who has economic ownership in the intangibles is entitled to additional returns. However, the difficult question is what should be the arm’s length price of such returns.

10.4.8.17. The important issue in the determination of ALP in these cases is to examine who benefits from the extraordinary AMP expenditure. Taxpayers generally claim that such extraordinary expenditure helps the business of the Indian entity in addition to the parent MNE. However, the tax authorities in India have found that Indian distributors are claimed to be no risk or low risk bearing entities and are receiving fixed and routine return on a cost plus basis. They do not receive a share in the excess profit related to local marketing intangibles. Accordingly, extraordinary AMP expenditure does not enhance the profitability of the Indian subsidiary or related party. This conclusion of the tax authorities is further supported by the fact that these so called risk-free or limited risk distributors have disclosed very large losses even when they are entitled for fixed return on cost plus basis and should not have incurred losses.

10.4.8.18. In this context, the transfer pricing administration has taken a view that such Indian entities (which incur excessive AMP expenses, bear risks and perform functions beyond what an independent distributor with similar profile would incur or perform for the benefit of its own distribution activities) should be compensated for the return on their intangibles. Such compensation would be in the form of reimbursement of the excess AMP expenditure along with mark-up. Alternatively, the Indian entity should be allowed to share profit related to marketing intangibles. If no reimbursement is made in these type of cases along with mark-up, or the related party does not receive an arm's length return for development of marketing intangibles in the form of its entitlement to share profits, the Indian tax administration makes an adjustment on account of reimbursement of excess AMP expenditure along with a mark-up for the functions undertaken by the subsidiary/related party.

10.4.9. Intra-group Services

10.4.9.1. Globalization and the drive to achieve efficiencies within MNE groups have encouraged sharing of resources to provide support between one or more locations by way of shared services. Since these intra-group services are the main component of "tax efficient supply chain management" within an MNE group, the Indian transfer pricing authorities attach high priority to this aspect of transfer pricing.

The tax administration has noticed that some of the services are relatively straight forward in nature, such as marketing, advertisement, trading, management consulting etc. However, other services may be more complex and can often be provided either on a stand-alone basis or as part of a package and are linked one way or another to the supply of goods or intangible assets. An example can be agency sale technical support which obligates the licensor to assist the licensee in setting up of manufacturing facilities, including training of staff.

10.4.9.2. The Indian transfer pricing administration generally considers the following questions in order to identify intra-group services requiring arm's length remuneration:

- Have the Indian subsidiaries received any related party services, i.e. intra-group services?
- What are the nature and details of services, including the quantum of services received by the related party?
- Have services been provided in order to meet the specific need of the recipient of the services?
- What are the economic and commercial benefits derived by the recipient of intra-group services?
- In comparable circumstances, would an independent enterprise be willing to pay the price for such services? and
- Would an independent third party be willing and able to provide such services?

10.4.9.3. The answers to the questions above enable the Indian tax administration to determine if the Indian subsidiary has received or provided intra-group services that require arms' length remuneration. Determination of the arm's length price of intra-group services normally involves the following steps:

- Identification of the cost incurred by the group entity in providing intra-group services to the related party;
- Understanding the basis for allocation of cost to various related parties, i.e. the nature of "allocation keys" used by the MNE;
- Considering whether intra-group services will require reimbursement of expenditure along with mark-up; and

- Identification of the arm's length price of a mark-up for rendering of services.

10.4.9.4. Identification of the services requiring an arm's length remuneration is one of the main challenges for the Indian transfer pricing administration. India believes that shareholder services, duplicate services and incidental benefit from group services do not give rise to intra-group services requiring arm's length remuneration. However, such a conclusion would need a great deal of analysis. The biggest challenge in determination of the arm's length price is the allocation of cost by using allocation keys. The nature of allocation keys generally varies with the nature of services. However, it is difficult to reach agreement between the tax administration and taxpayer on the appropriate allocation of keys.

10.4.9.5. The next challenge before the transfer pricing administration is a most commonly asked question; that of whether or not it is necessary for the services provider to make a profit. Typical example of this would include treatment of pass-through costs. Another important and difficult question is how to determine a percentage of mark-up and to fix the benchmark of mark-up. The fixing up of the cost base to compute the mark-up is another complex issue and it is a difficult decision to include or not to include various types of overhead.

10.4.9.6. A brief review of cases where adjustments have been made by the Indian transfer pricing administration has revealed that most MNE parents do not allow any profit mark-up on the services rendered to them by Indian subsidiaries. However, in some exceptional cases a low mark-up of 5 to 10 per cent is allowed on some services with a restricted cost base. On the other hand, where Indian subsidiaries or related parties receive intra-group services, parent MNEs generally charge a mark-up on all the services provided to such entities, including duplicate services, shareholding services and services which provide only incidental benefits to the Indian entities. The rate of mark-up charged on such intra-group services is mostly on the higher side. The Indian transfer pricing administration has also noticed that in several cases, the claim of rendering services was found to be incorrect or the services were found not to be intra-group services which required arm's length remuneration.

10.4.9.7. In view of the above facts, transfer pricing of intra-group services is a high risk area for the Indian transfer pricing administration.

10.4.10. Financial Transactions

10.4.10.1. Intercompany loans and guarantees are becoming common international transactions between related parties due to the management of cross-border funding within group entities of an MNE group. Transfer pricing of inter-company loans and guarantees are increasingly being considered some of the most complex transfer pricing issues in India. The Indian transfer pricing administration has followed a quite sophisticated methodology for pricing inter-company loans which revolves around:

- Examination of the loan agreement;
- A comparison of terms and conditions of loan agreements;
- The determination of credit ratings of lender and borrower;
- The identification of comparable third party loan agreements; and
- Suitable adjustments to enhance comparability.

10.4.10.2. The Indian transfer pricing administration has come across cases of outbound loan transactions where the Indian parent has advanced to its associated entities (AE) in a foreign jurisdiction either interest free loans or loans at LIBOR (London Interbank Offered Rate) or EURIBOR (Euro Interbank Offered Rate). The main issue before the transfer pricing administration is benchmarking of these loan transactions to arrive at the ALP of the rates of interest applicable on these loans. The Indian transfer pricing administration has determined that since the loans are advanced from India and Indian currency has been subsequently converted into the currency of the geographic location of the AE, the Prime Lending Rate (PLR) of the Indian banks should be applied as the external CUP and not the LIBOR or EURIBOR rate.

10.4.10.3. A further issue in financial transactions is credit guarantee fees. With the increase in outbound investments, the Indian transfer pricing administration has come across cases of corporate guarantees extended by Indian parents to its associated entities abroad, where the Indian parent as guarantor agrees to pay the entire amount due on a loan instrument on default by the borrower. The guarantee helps an

associated entity of the Indian parent to secure a loan from the bank. The Indian transfer pricing administration generally determines the ALP of such guarantee under the Comparable Uncontrolled Price Method. In most cases, interest rates quotes and guarantee rate quotes available from banking companies are taken as the benchmark rate to arrive at the ALP. The Indian tax administration also uses the interest rate prevalent in the rupee bond markets in India for bonds of different credit ratings. The difference in the credit ratings between the parent in India and the foreign subsidiary is taken into account and the rate of interest specific to a credit rating of Indian bonds is also considered for determination of the arm's length price of such guarantees.

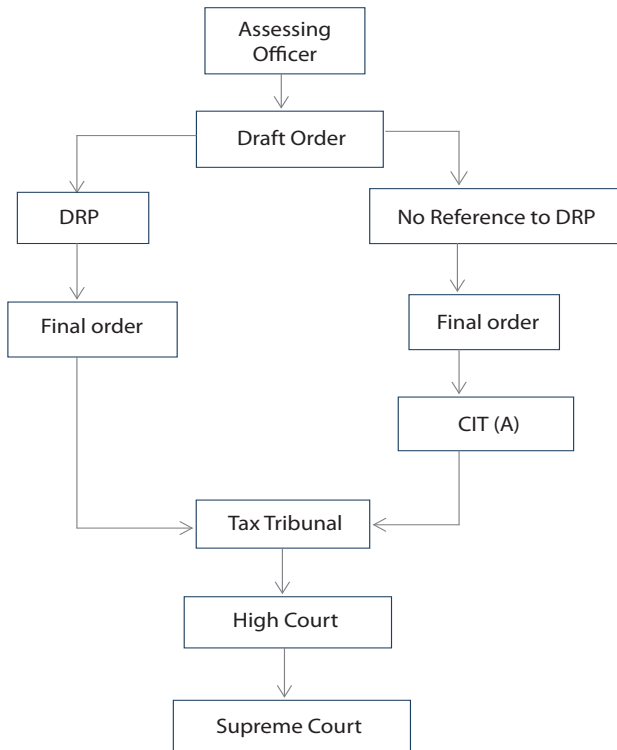
10.4.10.4. However, the Indian transfer pricing administration is facing a challenge due to non-availability of specialized databases and of comparable transfer prices for cases of complex inter-company loans as well as mergers and acquisitions that involve complex inter-company loan instruments as well as an implicit element of guarantee from the parent company in securing debt.

10.4.11. Dispute Resolution Process

10.4.11.1. A comprehensive dispute resolution mechanism is available to the taxpayers in India facing transfer pricing adjustments. As a part of the legal process in all cases, the Assessing Officer (AO) incorporates the order of the Transfer Pricing Officer (TPO) in his order and issues a draft order to the taxpayer. The taxpayer has the option to file an objection against the draft order before the Dispute Resolution Panel (DRP) which is a panel comprising three Commissioners of Income Tax. For cases referred to the DRP, the AO issues a final order in compliance with the directions of the DRP. In cases where the taxpayer chooses not to file an objection before the DRP, the draft order by the Assessing Officer incorporating the order of TPO becomes final and the taxpayer may file an appeal before the Commissioner of Income Tax (Appeals).

10.4.11.2. The sequence and availability of dispute resolution forums to the taxpayer in India can be depicted as follows.

10.4.11.3. The transfer pricing administration is more than a decade old in India. However, disputes are increasing with each transfer pricing audit cycle, due to the following factors:



- Cross-border transactions have increased exponentially in the last decade;
- Lack of international consensus on taxation of certain group cross-border transactions such as intangibles, financial transactions, intra-group services etc;
- Difficulty in applying the arm's length principle to complex transactions such as business restructuring;
- Taxpayers in India can postpone payment of tax liability by resorting to litigation; and
- Availability of multiple channels to resolve disputes in India.

10.4.11.4. The Indian tax administration is aware of the problem of increasing disputes and has taken several steps to reduce litigation and the time needed to resolve tax disputes. The steps taken by the Indian tax administration are:

- International transactions below Indian Rupee 150,000,000 (US\$ 3 Million) are not selected for transfer pricing audit;
- No adjustments are made in cases where the variation between the arm's length price determined and the price of the international transaction does not exceed 3 per cent or other notified percentage;
- Significant efforts have been made to provide certainty in the application of transfer pricing laws;
- There is a time limit for disposal of objection of the taxpayer by the DRP;
- Indicative time limits have been provided for various judicial forums;
- Direct appeal to the tax tribunal is provided against transfer pricing orders approved by the DRP;
- Dedicated and specialized appellate Commissioners and benches of tax tribunals have been put in place to deal with disputes on transfer pricing;
- The process for Mutual Agreement Procedure has been put on fast track; and
- An Advance Pricing Agreement Scheme is put in place.

10.4.11.5. India has also enacted legislative provisions for entering into Advance Pricing Agreements; the Scheme has been effective from 30 August 2012. An APA is an agreement between the Central Board of Direct Taxes and any person, which determines, in advance, the arm's length price or specifies the manner of the determination of arm's length price (or both), in relation to an international transaction. Once an APA has been entered into, the arm's length price of the international transaction will be determined in accordance with the terms of the APA for the period specified therein. The APA process is voluntary and will supplement appeal and other treaty mechanisms for resolving transfer pricing disputes. The APA term can be a maximum of five years.

10.4.11.6. There are three types of APA — unilateral, bilateral and multilateral — and the applicant may request a particular type when making the application. The scheme provides for a pre-filing consultation between the taxpayer and the APA team before formal application;

such consultation can also be on an anonymous basis. The formal APA application must be filed after the pre-filing consultation with specified fees.

10.4.11.7. India believes that tax disputes in the field of transfer pricing require concentrated efforts by all trading partner countries. The ability of a country to reduce disputes by taking unilateral legislative and administrative actions is very limited at a time when cross-border transactions amongst the related parties have increased substantially in the last decade. India appreciates efforts made by the United Nations Committee of Tax Experts to provide guidance on the application of transfer pricing law.

10.5. South Africa Country Practice

10.5.1. Introduction

10.5.1.1. South Africa's transfer pricing legislation as set out in Section 31 of the Income Tax Act 58 of 1962 came into effect on 1 July 1995 followed by Practice Note 2 introduced 14 May 1996 and Practice Note 7 introduced 6 August 1999. Both served to provide taxpayers with guidance on how the South African Revenue Service (SARS) intended to apply the legislation. Practice Note 2 covered thin capitalization whilst Practice Note 7 dealt with transfer pricing. As of 1 April 2012 the SARS has made several amendments to its transfer pricing rules.

10.5.1.2. The fundamental principle underpinning the South African transfer pricing legislation since inception has been the arm's length principle as set out in Article 9 of both the United Nations Model Double Taxation Convention between Developed and Developing Countries and the OECD Model Tax Convention on Income and Capital, as well as the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Transfer Pricing Guidelines). It is the stated intention of the SARS to provide an update to Practice Note 2 and Practice Note 7, following the amendments to the legislation, however at the time of this publication these had not been released.

10.5.1.3. South Africa is still in its infancy with respect to auditing related party cross-border transactions, even though transfer pricing concepts have been in existence in South Africa for some time. The

SARS has only in the last few years begun to aggressively audit transfer pricing owing mainly to a lack of resources and skills challenges. At the same time, South African companies belonging to multinational groups are also starting to focus on their transfer pricing compliance.

10.5.1.4. Whilst the OECD Transfer Pricing Guidelines have been particularly useful in providing a conceptual understanding of *what* is the nature of the arm's length principle, there are instances when the Guidelines fail to address the more practical aspects of *how* to apply the principle. This contribution shares South Africa's experience in applying the arm's length principle and shows how South Africa attempts to work around some of the practical shortcomings. Attention will be given to some broad themes as well as to some specific areas of challenge experienced in South Africa with respect to the application of the arm's length principle. This article is not an affirmation of the SARS's approach to all transactions as such approach remains specific to the facts and circumstances. The issues raised merely convey some of the challenges and experiences of the SARS in transfer pricing.

10.5.2. Comparability

10.5.2.1. The main challenge that South Africa encounters in determining arm's length profits is the lack of domestic comparables. The pursuit of the perfect comparable remains an elusive and almost unattainable feat. It is thus accepted that the *most reliable* comparables will suffice. The problem in South Africa is that this compromise is extended even further given that there are no databases containing South African-specific, or for that matter African-specific, comparable data. As a result, both the tax administration and taxpayer rely on European databases to establish arm's length prices or levels of profitability.

10.5.2.2. The obvious problem to which this gives rise has no simple or definitive solution. Instituting comparability adjustments to account for geographical differences (for example, market, economic, political differences etc) in order to improve the degree of reliability of the comparable data is often extremely complex and can in some instances have the reverse effect to what was intended, i.e. where after adjustment the comparable data is no longer comparable to the controlled transaction.

10.5.2.3. In practice the SARS has attempted to make comparability adjustments, for example country risk adjustments based on publicly available country risk ratings, government bond rates (sometimes referred to as the risk free rate) etc however these have been applied with caution and in specific circumstances.

10.5.2.4. Whilst South Africa may be worse off than many other countries because of not having any domestic comparable data, many other countries are likely to be in a similar position. As multinationals become more and more complex in their business models and as more widespread industry consolidation is achieved, finding comparable data and achieving reliability may not be South Africa's problem alone. It is perhaps already true that for certain types of large scale manufacturing and distribution activities, for example in the automotive industry, there is no independent comparable data anywhere.

10.5.2.5. It is for this reason, amongst others, that the SARS favours a more holistic approach to establishing whether or not the arm's length principle has been upheld. By seeking to understand the business model of taxpayers across the whole value chain, gaining an in-depth understanding of the commercial sensibilities and rationalities governing intra-group transactions and agreements etc. It is evident that the SARS does not look to comparable data alone or in isolation from other relevant economic factors in determining whether or not the appropriate price or arm's length level of profit has been achieved.

10.5.3. Management Services

10.5.3.1. As a result of an increased globalization, in order to achieve economies of scale and optimize efficiencies, it is becoming commonplace for multinationals to centralize the provision of certain services in a single entity. In the South African context there seem to be some favoured destinations such as Singapore, Hong Kong and the Netherlands.

10.5.3.2. The challenge in establishing whether or not payment for a service is at arm's length goes further than the two step approach set out in Chapter 7 of the OECD Transfer Pricing Guidelines, which stipulates that the test for establishing the arm's length nature of intra-group services is twofold. Firstly, it must be determined if a service

has been rendered and second, it must be determined if the charge for such service is arm's length (Paragraph 7.5 of the OECD Guidelines). As regards the first test, the approach followed is to determine if the services:

- Provide the recipient with economic and commercial benefit;
- Are not services that the recipient is already performing for itself (duplicate service test); and
- Are not shareholder services.

As regards the second part of the test, the audit approach seeks to confirm the following:

- That the cost base is appropriate to the services provided;
- That the mark-up is arm's length;
- That the allocation keys applied are commensurate to the services provided.

10.5.3.3. In particular, Paragraph 7.29 of the OECD Guidelines states that in determining the arm's length prices for intra-group services the matter should be considered from the perspective of the service provider and the recipient. Relevant considerations include the value of the service to the recipient and the costs to the service provider.

10.5.3.4. With regards to the determination of whether or not a service has provided the recipient with economic and commercial benefit, a demonstration of adherence to the arm's length principle becomes difficult. In practice this is becoming more and more subjective. The economic benefit of services cannot always be measured in actual monetary or other such quantifiable terms and as such it is often demonstrated by the assertion of the taxpayer rather than being a matter of fact. It is often reiterated that transfer pricing is not an exact science and tax administrations are encouraged to take into account the taxpayer's commercial judgement as well as their own. This becomes difficult when such judgement has the potential to translate into a significant tax adjustment for taxpayers.

10.5.3.5. A possible solution is for a tax administration to clearly set out its requirements for documentation and burden of proof. However this is likely to meet with resistance from taxpayers who will claim

that this places an increased compliance cost burden on them. The SARS is currently taking a pragmatic but firm approach to evaluating payments for intra-group services and where clear commercial justification or evidence of reasonableness for such payments are lacking, such payments are disallowed.

10.5.4. Contract Risk Shifting: Year-End Adjustments

10.5.4.1. There appears to be an increasing tendency for parent companies of South African subsidiaries to shift profits via a year-end adjustment to either the cost of goods imported by the South African subsidiary or directly to the operating margin, to bring the South African subsidiary in line with “comparable companies”. What occurs is usually a global policy change by the parent company aimed at limiting the return of its subsidiaries (including those based in South Africa) to a guaranteed return (determined by way of a comparable search). The change in policy is often followed by an introduction of year-end transfer pricing adjustments to ensure that South African entities achieve the often low targeted net margin while the residual profit is returned to the parent or holding company.

10.5.4.2. There is often little or no regard for the drivers of higher profits attained in South Africa when taxpayers compare themselves to comparable companies in foreign markets (given that there are no local comparables for South Africa). In such cases there is also often a lack of consideration for the actual functional and risk profile of the South African subsidiary. South African subsidiaries of multinational companies are frequently classified as limited risk distributors or limited risk manufacturers when in actual fact they are often much more than just limited risk entities. Furthermore, there are many instances where unique dynamics exist within the South African market enabling South African subsidiaries to realize higher profits than their related party counterparts in other parts of the world, or than are evidenced by comparable data obtained from foreign databases. For instance, the South African pharmaceutical and manufacturing industries are still unsaturated and offer ample opportunities for multinational companies to increase their profits. The increased participation and spending power of the middle class segment in the economy also offers a new market opportunity for certain industries.

10.5.4.3. Building on the practice followed in India and China, the SARS is currently considering its approach to location savings, location-specific advantages and market premiums etc within certain industries and such factors will be addressed when conducting audits.

10.5.5. Intangibles

10.5.5.1. As intangibles are “unique” in nature they raise unique transfer pricing challenges for both multinationals and tax administrations. Disputes which arise in South Africa relate to the existence of local marketing intangibles, issues of economic versus legal ownership and the valuation of intangibles.

10.5.5.2. In the South African experience, the sale of intangibles developed in South Africa presents a somewhat exceptional situation compared to the rest of the world, as exchange control regulations prohibit the relicensing of such intangible property back into South Africa. Once such intangible property is sold to an offshore related party, usually in a low-tax jurisdiction, the related party becomes the legal owner of the intangible property. This related party then licences out the intangible property worldwide (excluding South Africa) earning royalties. In addition, the terms and conditions of the original sale may dictate that the South African entity will continue to perform certain functions toward the enhancement and further development of the intangible property for which it earns a cost plus return. The related party, that is now the legal owner, in essence merely carries out activities relating to registration and maintenance of the intangible property and earns an intangible related return (in the form of royalties). Furthermore, if such intangible property were ever sold outside the group the South African entity would have no participation in any profits that may be realized.

10.5.5.3. The questions that arise are: whether or not such terms and conditions would have been agreed to at arm’s length and more importantly whilst legal ownership may have been transferred, can the South African entity be considered to have economic ownership?

10.5.5.4. From the perspective of the SARS there is merit in the argument that economically the ownership resides with the South African entity and as such the entity should be earning an intangible related

return. Given the true functional and risk profile of the related party, the related party should be compensated as a service provider for registration and maintenance of the intangible property.

10.5.5.5. There is no one size fits all approach to these issues and it is the approach of the SARS to adopt a case by case stance depending on the facts and circumstances.

10.5.6. Access to Information

10.5.6.1. Another major challenge faced by the SARS when conducting transfer pricing audits is that posed by the creative tactics adopted by taxpayers to circumvent responding to SARS questions and providing the information requested. This approach often leads to long and drawn out audits. Taxpayers prefer the use of costly advisors and advocates to find ways of not responding to the request of the SARS audit rather than providing relevant information or arguing the technical points raised.

10.5.6.2. In addition, it is also fairly common for taxpayers to present arguments they themselves cannot substantiate or to make disclosures to the SARS and subsequently retract them. Taxpayers can often illustrate what was done however they can seldom explain *why*. Such interactions make it difficult for the SARS to reach reliable audit findings.

10.5.7. Conclusion

10.5.7.1. The arm's length principle presents several challenges in terms of application. The hypothesis required to approximate transactions between related parties to what would have transpired had they been independent can be difficult and, as stated, finding reliable comparables and making comparability adjustments is easier said than done. It is however the most workable solution at this current time and its limitations can be overcome. In the South African context, whilst taxpayers may seek to exploit the limitations of the arm's length principle to their advantage the SARS remains undeterred. The arm's length principle does not ignore basic principles such as the perspective of the prudent business man, commercial rationale and good business practice. It is with this understanding that the SARS applies the arm's length principle.

Appendix I

[CHAPTER 5 — COMPARABILITY]

- Part 1: Example Related to Functional Analysis**
(manufacturing entity)
 - Part 2: Example Related to Functional Analysis** *(distributor)*
 - Part 3: Functional Analysis Checklists**
 - Part 4: Case Study Based on a Hypothetical Example**
-
- Part 1: Example Related to Functional Analysis**
(manufacturing entity)

AI.1.1. Facts of the Case

ABC & Co is incorporated and registered under the laws of Country A. ABC & Co owns technology related to engines used for manufacturing of cars. It also has a share in the market for supply of spare parts and tyres. It is a 100 per cent, i.e. wholly-owned, company of XYZ & Co. XYZ & Co is incorporated and registered under the laws of Country B. It is engaged in the manufacturing of cars. XYZ & Co has entered into an agreement to use the core technology related to engines with ABC & Co. It also purchases spare parts and tyres from ABC & Co. XYZ & Co thus uses this technology and material purchased from ABC & Co in the manufacturing of cars and in turns sells it to third parties on behalf of ABC & Co. ABC & Co has in-house R&D with facilities to strengthen its capabilities by innovating and developing new/improved technology. The R&D centre interacts closely with the marketing department to evaluate trends in sales and profitability and communicates with other departments to keep a close track of new technologies which may be acquired and in-sourced.

With the above background, the international transaction between ABC & Co and XYZ & Co can be described as that of a purchase of technology from ABC & Co. For the purpose of FUNCTIONAL

ANALYSIS explained below, an analysis of their transactions can be indicated by the symbols noted below. The summary of the Functional Analysis follows:

Table A.1: Summary of Functional Analysis (*key to symbols used*)

Symbol	Comparative Functional Level Standards	Comparative Risk Level Standards	Comparative Assets Employed
-	No functions	No risk exposure	No assets employed
*	Least functions	Lowest exposure	Least assets employed
**	Lesser functions	Medium exposure	Medium assets employed
***	Highest functions	Highest exposure	Highest assets employed

AI.1.2. Functions Performed

Some of the typical business functions that are generally performed in a business transaction are as follows:

1. Product research, design and development;
2. Purchasing material and inventory management;
3. Production planning and scheduling;
4. Quality control;
5. Establishing and controlling pricing policies;
6. Sales and distribution;
7. Marketing and advertising;
8. Administrative services; and
9. After sales and support services.

The above list is purely indicative and shall apply to the extent possible depending upon the industry and taxpayers specific circumstances.

Several functions are particularly important while conducting functions performed by a manufacturing company. For instance does the parent corporation purchase raw material on behalf of its manufacturing subsidiary, does it direct its subsidiary on purchasing or does the manufacturing company purchase the raw material on its own? The selection of materials shall have an impact on the pricing policy of the final product and quality of the finished goods and other areas of business process.

A summary of functions performed by ABC & Co and XYZ & Co follows:

Table A.2: Summary of Functions Performed (*example*)

Description of Function	ABC & Co	XYZ & Co	Comments
Research and development	*	**	<p>ABC & Co It is assumed that it has its own R&D centre for development of engines which forms the integral part of the car. It has technology which is supplied by XYZ & Co.</p> <p>XYZ & Co It is assumed that XYZ Co is dependent on ABC & Co for their technology of engines to be used for manufacturing of cars. It has its own R&D centre to absorb the technology and to customize it to suit local conditions.</p>
Product development	*	**	<p>ABC & Co It is assumed that it supervises the product development activities undertaken by XYZ & Co.</p> <p>XYZ & Co It is assumed that it undertakes the activities related to product development which includes designing, product specifications, understanding market trend, focusing on competitors and studying product life cycle.</p>
Procurement of materials and production scheduling	*	***	<p>ABC & Co It is assumed that ABC & Co supplies spare parts and tyres used for manufacturing of the car.</p> <p>XYZ & Co It is assumed that other raw materials required are purchased directly by XYZ & Co. Production scheduling is undertaken by XYZ & Co depending upon the demand for the product in the market.</p>
Quality control	*	***	<p>ABC & Co It is assumed that quality control policy and procedures, and monitoring them from time to time are laid</p>

Description of Function	ABC & Co	XYZ & Co	Comments
			<p>down by ABC & Co in a technology agreement and nothing further is being done by them.</p> <p>XYZ & Co It is assumed that XYZ & Co does not have any power to alter these policies and procedures. Quality control is an important function since it helps the product to maintain the desired standard in order to survive in the market.</p>
Inventory management	-	***	<p>XYZ & Co It is assumed that XYZ & Co follows the just-in-time policy to manage inventory which in turn helps in balanced production and maintenance of required stock levels.</p>
Pricing policy	-	***	<p>XYZ & Co It is assumed that XYZ & Co is to decide pricing policy keeping in mind the local conditions and market acceptability and reasonable prices for raw materials procured from the open market.</p>
Market development	-	***	<p>XYZ Co It is assumed that research on various geographical areas (domestic) where the market can be developed is done by XYZ & Co. Market development would include focus on both existing customers as well as potential new customers.</p>
Sales and distribution		**	<p>ABC & Co It shall supervise and direct the selling and distribution of the product to the customers.</p> <p>XYZ & Co It shall follow the directions and undertake the selling and distribution activities.</p>
After sales service	-	***	<p>ABC & Co It is assumed that ABC & Co will not be responsible for any after sales</p>

Description of Function	ABC & Co	XYZ & Co	Comments
	-	***	services except for services to be rendered for defects in engines due to technology owned by ABC & Co. XYZ & Co It shall provide after sales and support services to all customers in the event of customer grievances and returns/ exchanges.
Administration	**	**	It is assumed that ABC & Co and XYZ & Co will perform administration functions independently for their respective organizations based on policies framed.

AI.1.3. Assets Employed

In the course of an international controlled transaction all the significant assets both tangible and intangible employed in the transaction need to be identified and analysed. The following is a typical list of tangible and intangible assets employed in the business:

Tangibles:

- Land and buildings;
- Plant and machinery;
- R&D equipment;
- Office equipment; and
- Computers.

Intangibles:

- Patents;
- Trademarks and brand names;
- Licensed copyrights; and
- Customer lists.

The following is the summary of assets employed by ABC & Co and XYZ & Co:

Table A.3: Summary of Assets Employed (*example*)

Description of Assets	ABC & Co	XYZ & Co	Comment
Tangibles			
	-	***	It is assumed that XYZ & Co has employed its tangible assets in the manufacture of the final product. XYZ & Co is also the legal owner of such tangible assets.
Intangibles			
Technology	***	**-	It is assumed that XYZ & Co is dependent on ABC & Co for technology related to engines used for manufacturing cars, which, technology forms an integral part of the engines. XYZ & Co also has its own R&D facilities and it develops new products and further improves current products based on market trends and user-specific requirements.
Brand	*	**	It is assumed that XYZ & Co uses a brand name developed by ABC & Co over the years in order to reach the target customers. Since XYZ & Co provides funds to develop the said brand in the local market, it may share in the return to the brand intangible (i.e. the economic ownership of the brand in the local market belongs to XYZ & Co).

AI.1.4. Risks Assumed

A significant portion of the rate of return (ROR) earned by a company reflects the fact that business is exposed to risks of various kinds. Risks analysis involves the identification of economically significant risks that are assumed by each of the parties to the transaction. Some of the risks that are generally a part of business are as follows:

- Market risks;
- Inventory risks;
- Credit risks;
- Defective products and warranty;
- Foreign exchange risks; and
- Environmental risks.

Table A.4: Summary of Risks Assumed (example)

Risk Category	ABC & Co	XYZ & Co	Comment
Market risk	-	***	<p>ABC & Co It is assumed that the company does not have significant exposure to risks. It is primarily involved in the development of technology related to engines.</p> <p>XYZ & Co It is assumed that XYZ & Co has a significant exposure to market risks since it is responsible for the development of the market in order to create consumer demand.</p>
Technology risk	***	**	<p>ABC & Co It is assumed that ABC & Co bears a significant exposure to technology risks as it is the technology owner of the main part of the finished goods. Due to the chances of the technology becoming obsolete it is a challenge for the company to keep up with the developments in technology in order to face market competition.</p> <p>XYZ & Co It is assumed that XYZ & Co is exposed to significantly less technological risk than ABC & Co. It faces the risk of the manufacturing process becoming obsolete.</p>
Inventory risk	-	***	<p>ABC & Co It is assumed that ABC & Co is not exposed to inventory risk since it is not involved in inventory maintenance and management. It is involved in technology development.</p> <p>XYZ Co It is assumed that XYZ Co is responsible for procurement and maintenance of requisite stock level, however the risk is mitigated due to the just-in-time policy being followed by XYZ Co.</p>

Risk Category	ABC & Co	XYZ & Co	Comment
Foreign currency risk	**	**	<p>ABC & Co It is assumed that ABC & Co exports technology to XYZ & Co and that these exports are subject to appreciation/depreciation of local currency against the foreign currency. Hence ABC & Co is subject to this risk.</p> <p>XYZ & Co It is assumed that XYZ & Co imports technology and components from ABC & Co and that these imports are subject to appreciation/depreciation of local currency against the foreign currency. Hence, XYZ & Co is subject to this risk.</p>

Part 2: Example Related to Functional Analysis (*distributor*)

B Co is a manufacturer of machine tools worldwide. It has a single manufacturing facility in Country X. A Co, a limited liability company incorporated in Country Y, is set up to develop the market and provide support in Country Y.

A Co acts as a distributor of products manufactured by B Co. A Co performs the function of providing marketing and local sales promotion support to B Co and its dealers to increase the sale of products manufactured by B Co. A Co also provides technical support services in respect of the products sold to customers for resolving technical issues faced by them.

Accordingly, A Co is assumed to be engaged in the following intra-group transactions with its associated enterprise B Co:

- To act as a distributor of products manufactured by B Co. These products purchased from B Co will in turn be sold to customers in Country Y;
- To provide marketing support services to B Co to increase the sale of products manufactured by B Co by establishing awareness about the features of the products in the market of Country Y; and
- To provide technical support in respect of technical issues that cannot be resolved by customers.

AI.2.1. Functions Performed

AI.2.1.1. Description of Functions Performed by B Co

a. Market Development

It is assumed that B Co undertakes the market development activities with respect to sale of products to third party customers. Hence, it needs to keep itself abreast of market trends and developments. Such activities include gathering relevant information on the market and market trends, availability of product substitutes, actions of competitors, development of product variations for additional applications etc. But this is restricted to all countries other than Country Y.

b. Product Development

It is assumed that product development is undertaken by B Co. Product development involves product engineering, designs, research for product improvements, observance of national and international standards for the product etc.

c. Product Procurement/Production Scheduling

It is assumed that B Co manufactures the products using its own manufacturing facilities. The procurement process for the raw material for manufacture of the product is based on prudently prepared sales forecasts. The procurement function and the ordering processes are undertaken by B Co under which factors such as lead time, availability, negotiations, etc are taken into consideration when deciding the party from which raw materials or other inputs are to be purchased.

d. Quality Control

It is assumed that B Co undertakes quality control processes in order to ensure that the products sold to the end customer match with the contractual specifications, as well as national and international quality standards. This is a critical activity because failure to ensure quality control may invite reputation risk and product liability risk.

e. Post Sales Activities

It is assumed that contractual and non-contractual product warranties are provided to customers by B Co.

AI.2.1.2. Description of Functions Performed by A Co

a. Procurement of Products

It is assumed that A Co places purchase orders for the products of B Co based on estimated demand calculated on the basis of the number and type of products in demand in Country Y. The procurement process for products is also based on purchase orders placed by customers with A Co for products which are not in stock in Country Y. Thus, procurement and the ordering processes are to be performed by A Co.

b. Inventory Management

It is assumed that A Co is responsible for managing the procurement of products as well as maintaining the requisite inventory levels of the products as per customer orders.

c. Quality Controls

It is assumed that A Co shall undertake a limited quality control function for the products traded by it in order to ensure that the products match with the contractual specification of the end customers.

d. Post Sales Activities

A Co is responsible for post sales activities involving collection of payments from customers, liaison with customers, addressing technical issues if any, etc. In case of defects, A Co shall take steps to remove any defects or replace defective products.

e. Selling and Marketing

A Co involves itself in promotion of products in Country Y and carries all functions of marketing, selling and developing a customer base in Country Y, thereby creating a marketing brand in Country Y. A Co is to coordinate the marketing activities in Country Y.

f. Technical Activities

Service problems in respect of the products may be referred to A Co which will provide technical support accordingly.

AI.2.2. Summary of Functions Performed

AI.2.2.1. Assets Employed

Table A.5: Summary of Assets Employed for Functions Performed (example)

Description of Functions	B Co	A Co
Market development	-	***
Product development	***	-
Product procurement/Production scheduling	-	***
Inventory management	-	***
Manufacturing	***	-
Quality controls	***	*
Selling and marketing	-	***
Post sales activities	-	***
General management functions		
Corporate strategy determination	**	**
Finance, accounting, treasury and legal	**	**
Human resource management	*	***
Technical support activities	*	**

Any business requires assets (tangible or intangible) without which it cannot carry out its activities. An understanding of the assets employed and owned by associated enterprises to the transaction provides an insight into the resources deployed by them and their contribution to the relevant business processes/economic activities.

1. Transaction-specific Tangible and Intangible Assets

- a) The following routine tangible assets are expected to be employed by A Co:

Product distribution activity

- Warehouse facilities;
- Inventory management systems;
- Personnel.

Provision of marketing and sales support

- Personnel;
- Computer systems;
- General office facilities.

Provision of technical support

- Personnel;
- Tools and ancillary equipment;
- Computer systems;
- General office facilities.

- b) B Co being a manufacturer and global supplier employs larger and expanded levels of tangible assets and human resources in relation to its business. However A Co being a distributor in Country Y, all the personnel required for distribution is employed by them; though A Co may not have sizable tangible assets it will have assets such as networks of offices, showrooms and warehouses in the country.

Apart from the above assets, the following are the general intangible assets employed:

2. Generally Employed Intangible Assets

- a) It is assumed that all research and development efforts are carried out by B Co. A Co would endeavour to provide B Co with information specific to their market, customers, competitors and external environment which could contribute to meaningful adaptations or enhancements in the manufacture of the products.
- b) It is further assumed that A Co will use the trademarks, process, know-how, operating/quality standards etc developed/owned by B Co free of cost. A Co will leverage from these intangibles for continued growth in revenues and profits.
- c) Apart from the above intangibles, B Co, due to its long standing in the business, has developed/built up goodwill, marketing expertise, skill and experience, networks, customer databases, and local marketing intangibles, etc.

AI.2.2.2. Summary of Assets Employed

Table A.6: Summary of Assets Employed (example)

Assets Employed	B Co	A Co
Tangibles	***	**
Intangibles	***	**

AI.2.2.3. Risk Analysis

1. Market Risk

A Co: It is assumed that the ultimate sale of products to end customers is done by A Co and therefore it bears substantial market risk.

B Co: A share of the market risk with respect to the products including supply, customer service and acceptance is also borne by B Co since it is the manufacturer of the products. However, risk is limited because of the major responsibility for market development in Country Y of A Co.

2. Product Liability Risk

A Co: A Co is merely a distributor of the product and therefore, it does face product liability risk to some extent for sale of products.

B Co: B Co is responsible for technology relating to manufacture and also manufacturing of products and therefore it faces the product liability risk arising from any defects in manufacturing.

3. Credit Risk

A Co: It is assumed that all the major credit risks associated with sales to end users are borne by A Co.

B Co: A share of the credit risk is borne by B Co also as they are the manufacturers of the products.

4. Inventory Obsolescence Risk

A Co: It is responsible for the procurement of products and to maintain the requisite inventory levels. It faces the risk of slow moving/obsolete inventory.

B Co: It bears the risks associated with carrying inventory for the finished products including risk of obsolescence.

5. Foreign Currency Risk

A Co: It is exposed to foreign exchange fluctuation risk in the course of import of products from the manufacturer.

B Co: It is exposed to risk of foreign exchange fluctuations due to imports made by it from suppliers of raw materials and also exports of products to A Co.

6. Technology Risk

A Co: It does not face any technology risk, since all technologies are owned by B Co.

B Co: Since the technology for manufacture of machines is owned by B Co, it assumes substantial technology risk.

7. R&D Risk

A Co: It is assumed that A Co is merely a distributor of product and therefore, it does not face any R&D risk.

B Co: B Co is responsible for technology relating to manufacture and also manufacturing of products and therefore it faces R&D risk arising from defect in manufacturing and technology obsolescence.

8. Financing Risk

A Co: It is assumed that A Co is merely a distributor of products, therefore it does not carry substantial risk.

B Co: It is assumed that B Co is responsible for methods of funding, fluctuation of interest rates, funding of losses, etc. It therefore faces substantial financing risk.

9. Collection Risk

A Co: Being a distributor, A Co faces credit risk and bad debt risk. It therefore assumes substantial collection risk.

B Co: It is assumed that B Co does not face the collection risk, i.e. credit risk and bad debt risk.

10. Entrepreneurial Risk

A Co: It is assumed that A Co is merely a distributor; it does not face any entrepreneurial risk.

B Co: It is assumed that B Co is responsible for risk of loss associated with capital investment, single customer risk and risk of losing human capital intangible, thus B Co carries substantial entrepreneurial risk.

11. General Business Risk

A Co: It is assumed that A Co is merely a distributor; it does not carry any substantial general risk.

B Co: It is assumed that B Co is responsible for risk related to ownership of property, risk associated with exploitation of a business, inflation risk, etc. Thus, it bears major general risk.

12. Country/Regional Risk

A Co: Since A Co operates only in Country Y, it faces substantial country/regional risk (i.e. political risk, security risk, regulatory risk, risk related to government policies).

B Co: B Co operates in several countries other than Country Y, thus it does not assume any country/regional risk.

AI.2.2.4. Summary of Risks

Table A.7: Summary of Risks Assumed (example)

Risk Assumed	B Co	A Co	Risk Assumed	B Co	A Co
Market risk	-	***	R&D risk	***	-
Product liability risk	***	-	Financing risk	**	*
Credit risk	-	***	Collection risk	-	***
Inventory obsolescence risk	**	**	Entrepreneurial risk	***	-
Foreign currency risk	***	***	General risk	**	**
Technology risk	***	-	Country/Regional risk	**	**

Part 3: Functional Analysis Checklists

AI.3.1. Functions

Table A.8: Functional Analysis (*checklist*)

No.	Type of Function	Particulars	Points to be Considered
1.	Purchase function	<ul style="list-style-type: none"> • Selecting of supplier • Negotiation of prices • Determination of prices • Placing orders for goods • Receiving goods and inspection of the same • Quality check • Payment of invoices and maintenance of records 	
2.	Manufacturing function	<ul style="list-style-type: none"> • Research and development • Production, planning and scheduling • Setting up quality standards • Implementation of quality standards 	
3.	Distribution functions	<ul style="list-style-type: none"> • Maintenance of distribution network • Warehousing of finished goods inventory • Perform inventory control • Providing after sales services 	
4.	Sales function	<ul style="list-style-type: none"> • Market development including reaching target customers, studying competitors • Brand development • Trademark awareness • Advertisement activity • Selling goods to end users or distributors • Determining sale personnel needs • Setting remuneration of sales personnel • Providing after sales services 	
5.	After sales services function	<ul style="list-style-type: none"> • Warranty on normal service obligations • Warranty on manufacturing faults • Handling customer complaints • Handling billing and collection • Providing technical support to customers • Performing product repairs 	
6.	Marketing function	<ul style="list-style-type: none"> • Developing marketing strategy • Conducting market research • Undertaking market surveys • Control/coordinate marketing activities 	

7	Product strategy function	<ul style="list-style-type: none"> • Developing promotional activities • Coordinating market strategy implementation • Designing packaging material • Identifying needs for goods modification • Introduction of new goods in the market place 	
8.	Accounting function	<ul style="list-style-type: none"> • Preparing of financial statements • Collecting receivables • Payment of liabilities 	

AI.3.2. Assets

Table A.9: Intangible Assets Employed: Possible Issues (*checklist*)

No.	Assets Employed	Particulars	Points to be Considered
	Intangibles		
1.	Patents	The term patent usually refers to the right granted to anyone who invents any new, useful, and non-obvious process, machine, article of manufacture, or composition of matter.	<ul style="list-style-type: none"> • Are any patents owned? • How significant are they to the business?
2.	Trademarks	Trademarks serve to identify a particular business as the source of goods or services.	<ul style="list-style-type: none"> • Are any trademarks owned? • How significant are they to the business? • Which party has created trademark awareness and has enhanced its value in the market?
3.	Brand names	The brand name is one of the brand elements which help the customers to identify and differentiate one product from another.	<ul style="list-style-type: none"> • Are any brand names owned? • How important are they to the business? • Which party has created brand awareness and has enhanced its value in the market?
4.	Licenses	Official or legal permission to do or own a specified thing.	

5.	Copyrights	Copyright owners have the right to control the reproduction of their work, including the right to receive payment for that reproduction.	
6.	Unpatented technical know how		

Table A.10: Tangible Assets Employed: Possible Issues (*checklist*)

No.	Assets Employed	Particulars	Points to be Considered
	Tangibles		
1	Land and building		
2	Furniture and fixtures		
3	Computers		
4	Plant and machinery		

AI.3.3. Risks

Table A.11: Risks Assumed: Possible Issues (*checklist*)

No.	Type of Risk	Particulars	Points to be Considered
1.	Market risk	Market risk arises when a company is subject to adverse sales conditions due to increased competition, inability to develop the market, inability to reach target customers etc	<ul style="list-style-type: none"> • What constitutes the market risk? • Who bears the market risk? • How significant is the market risk?
2.	Inventory risk	Inventory risk relates to the potential losses that are associated with carrying finished product inventory.	<ul style="list-style-type: none"> • Does inventory become obsolete? • Who bears the cost of obsolete inventory? • Who provides warranties in relation to finished goods? • Who bears the cost of returns/repairs under warranty? • How significant is the inventory risk?
3.	Customer credit risk	When a company supplies products or services to a customer in advance of customer payment,	<ul style="list-style-type: none"> • What credit terms are given and received?

		the company runs a risk that the customer will fail to make payment. This risk is known as customer credit risk.	<ul style="list-style-type: none"> • Who bears the cost of bad debts? • How significant is the customer credit risk?
4.	Product technology risk	Product technology risks relate to the implications of changes in the particular market. The risk of obsolescence or stranded assets in response to behavioural or technological change is a form of product risk.	
5.	Foreign exchange risk	Exchange rate risk relates to the potential variability of profits that can arise because of changes in foreign exchange rates.	
6.	Warranty product liability risk	Product liability arises when a product fails to perform at accepted or advertised standard,	
7.	Scheduling/ Production risk	Scheduling/production risk relates to uncertainty involved in scheduling production in response to unpredictable fluctuations in demand or production flow.	
8.	Operational risks	It relates to the physical performance of the assets operated and managed by the business, and the scope for them to be affected by events beyond a business's control.	
9.	Financial risks	It relates to the relationship between the firm's revenue and its financing costs.	
10.	Volume risk	Volume risk is a function of the way in which companies derive their revenue. To the extent that the comparable companies are exposed to volume risk, forecasting risk which relates to the forecasts of costs and revenues becomes an issue. It is not possible to form a definitive view of the expected costs associated with this risk for inclusion in the cash flows.	

11.	Asset redundancy risk	A firm's assets might become obsolete or redundant in response to a shift in customer demand.	
12.	Infrastructure failure risk	It can be in relation to its own assets that might not be covered by insurance. It might be possible to form a view of the expected costs associated with infrastructure failure risk for inclusion in the cash flows.	
13.	Service incentive scheme risk	This risk is associated with the operation of service incentive schemes (e.g. reliability and service performance), to the extent that their actual performance might be a function of factors outside their control.	
14.	Foreign investment risk	This is the risk associated with investing in one country, but with shareholders in another country. It is not accounted for in estimates of the cost of capital using the CAPM. It might be possible to develop some indication of the likely costs associated with this risk for inclusion in the cash flows because of the size of the foreign exchange market.	
15.	Inflation risk	This is the risk that expected inflation might differ from actual inflation. It is possible to provide an indication of the expected loss of managing this risk. Alternatively, it would be possible to develop an approach to regulation that directly compensates the business for bearing this risk.	
16.	Real interest rate risk	This risk is associated with locking in the interest-free rate assumed. It is unlikely to be possible to form a definitive view of the expected costs associated with this risk for inclusion in the cash flows although there is market evidence that might assist in this process.	

17.	Personnel risk	This risk is associated with the attrition of skilled/trained personnel which involves time and cost overruns to replace.	
18.	Capacity utilization risk	This risk arises when the installed capacity for a manufacturer or service provider is not optimally utilized and the companies have to bear fixed costs associated with excess capacity.	

Part 4: Case Study Based on a Hypothetical Example¹⁰⁰

AI.4.1. Background

XYZ & Co is a manufacturer of cement and mortar in Country A. XYZ & Co has a state-of-the-art cement and mortar manufacturing complex in Country A. XYZ & Co manufactures a wide range of high-quality and competitively priced different types of cement and mortar which is marketed under its own brands. XYZ & Co's products and production processes are benchmarked with the best global products and processes as "touchstones", and meet the most rigorous international specifications. XYZ & Co's products go into end-use applications in the building and construction industry and are exported to a variety of world markets.

XYZ & Co procures the raw material, i.e. crushed limestone and gravel from ABC & Co, an associated enterprise (AE), situated in Country B, for manufacturing cement and mortar. ABC & Co is incorporated in Country B and is engaged in the business of quarrying of limestone and crushing the quarried limestone rocks into crushed limestone, gravel, etc.

Product profile of XYZ & Co and associated enterprise

a. Limestone

Limestone is a sedimentary rock composed primarily of calcium carbonate with the occasional presence of magnesium.

¹⁰⁰The following example builds upon knowledge drawn in large part from material freely available on the Internet, in particular Wikipedia. Such Internet sites may be a useful source of background information.

Most limestone is biochemical in origin meaning the calcium carbonate in the stone originated from shelled oceanic creatures. Limestone can also be chemical in origin as is the case with travertine. Chemical limestone forms when calcium and carbonate ions suspended in water chemically bond and precipitate from their aquatic sources. Because of its high calcium content, limestone is usually light in colour, although many variations exist. Commercially, the term limestone includes dolomite, dolomitic limestone, oolitic limestone, and travertine, a porous calcitic rock that is commonly formed near hot springs. Limestone is most commonly employed as rough block for building and construction. Additionally, it is used as dressed stone in various applications including curbing, panelling, veneer, and tile. Two general phases of limestone production exist i.e. quarrying and processing.

b. Gravel and Crushed Stone

Gravel is composed of unconsolidated rock fragments that have a general particle size range and include size classes from granule to boulder-sized fragments. Large gravel deposits are a common geological feature, being formed as a result of the weathering and erosion of rocks. The action of rivers and waves tends to pile up gravel in large accumulations. Crushed Stone is generally limestone or dolomite that has been crushed and graded by screens to certain size classes. It is widely used in concrete and as a surfacing for roads and driveways, sometimes with tar applied over it. Crushed stone may also be made from granite and other rocks. A special type of limestone crushed stone is dense grade aggregate, also known as crusher run, or colloquially as “crush and run”. This is a mixed grade of mostly small crushed stone in a matrix of crushed limestone powder.

c. Cement

Crushed limestone which is purchased from AE by XYZ & Co is used in the manufacture of cement. Cement is made by heating limestone (calcium carbonate) with small quantities of other materials (such as clay) to 1450°C in a kiln, in a process known as calcination, whereby a molecule of

carbon dioxide is liberated from the calcium carbonate to form calcium oxide, or quicklime, which is then blended with the other materials that have been included in the mix. The resulting hard substance, called “clinker”, is then ground with a small amount of gypsum into a powder to make “Ordinary Portland Cement”, the most commonly used type of cement (often referred to as OPC). Portland cement is a basic ingredient of concrete, mortar and most non-specialty grout. The most common use for Portland cement is in the production of concrete. Concrete is a composite material consisting of aggregate (gravel and sand), cement, and water. As a construction material, concrete can be cast in almost any shape desired, and once hardened, can become a structural (load bearing) element. Portland cement may be grey or white.

d. Mortar

Lime mortar is a type of mortar composed of lime and an aggregate such as sand, mixed with water. A pozzolanic material such as calcined clay or brick dust may be added to the mortar mix. This has a similar effect of making the mortar set reasonably quickly by reaction with the water in the mortar. Using Portland cement mortars in repairs to older buildings originally constructed using lime mortar can be problematic. This is because lime mortar is softer than cement mortar, allowing brickwork a certain degree of flexibility to move to adapt to shifting ground or other changing conditions. Cement mortar is harder and allows less flexibility. The contrast can cause brickwork to crack where the two mortars are present in a single wall.

Lime mortar is considered breathable in that it will allow moisture to freely move through it and evaporate from its surface. In old buildings with walls that shift over time, there are often cracks which allow rain water into the structure. The lime mortar allows this moisture to escape through evaporation and keeps the wall dry. Repainting or rendering an old wall with cement mortar stops this evaporation and can cause problems associated with moisture behind the cement.

AI.4.2. Functions, Assets and Risk Analysis

AI.4.2.1. Objective

Every person who has entered into an intra-group transaction shall keep and maintain, inter alia, a description of the functions performed, risks assumed and assets employed or to be employed by the taxpayer and by the associated enterprises involved in the intra-group transaction.

A functional analysis enables mapping of the economically relevant facts and characteristics of transactions between associated enterprises with regard to their functions, assets and risks. A functional analysis facilitates characterization of the associated enterprises and assists in establishing degree of comparability with similar transactions in uncontrolled conditions.

In dealings between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, comparison of the functions taken on by the parties is necessary. This comparison is based on a functional analysis, which seeks to identify and compare economically significant activities and responsibilities undertaken or to be undertaken in the uncontrolled transaction and controlled transaction between associated enterprises and their contribution to the overall economic value created.

Typically, an enterprise could be said to be performing one or all of the following broad economic functions, that is manufacturing, trading/distribution and providing services. The nature and extent to which these broad functions are performed by enterprises would vary. Within these broad economic functions of enterprises, the functions that one needs to identify and compare include e.g. design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing and management. Economically significant functions performed by an enterprise under examination are identified. Adjustments are made for any material differences in the significant economic functions undertaken in comparable uncontrolled transaction and in controlled transaction.

This analysis also considers the type and nature of assets used i.e. tangibles, such as plant and equipment, and intangibles, such as patents and

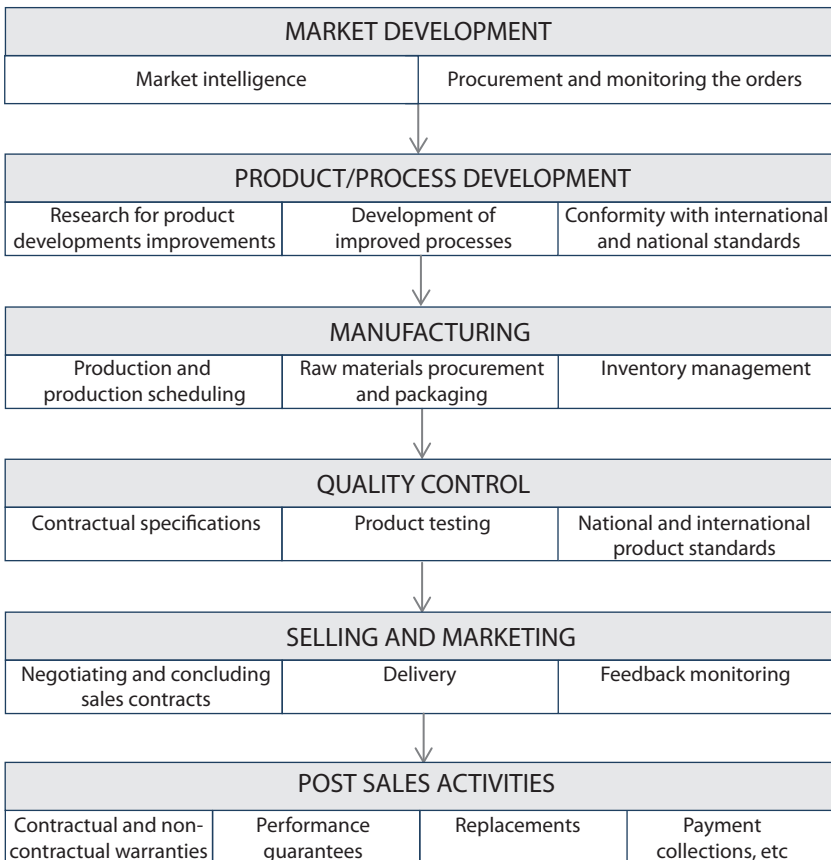
trademarks. It will also be relevant to consider the risks assumed by the respective parties. In the open market, the assumption of increased risk will also be compensated by an increase in the expected return.

In subsequent paragraphs, FAR analysis of intra-group transactions of purchase of raw materials by XYZ & Co from its associated enterprise is reflected.

AI.4.2.2. Functions Performed

As mentioned earlier, XYZ & Co and its associated enterprises operate in quarrying and crushing of limestone and gravel, manufacture of cement and mortar. The business broadly involves the following significant economic activities:

Table A.12: Business Process (example)



Functions performed by XYZ & Co in intra-group transactions of import/purchase of raw material

1. Overview of Business Process

The business process related to intra-group transaction of import of raw material from associated enterprise and its use by XYZ & Co for manufacture of the ultimate final product involves certain economically significant activities.

XYZ & Co uses these raw materials (crushed limestone and gravel) for the manufacture of ultimate final products (cement and mortar) and subsequent sale thereof. Economically significant functions, in this respect, performed by XYZ & Co, are as follows:

a. Market Development

XYZ & Co, being an entity manufacturing and selling final products, needs to keep abreast of market trends and developments. Such activities include gathering relevant information on market, trends, availability of product substitutes, actions of competitors, development of product variations for additional applications, etc.

b. Research and Development

R&D is of significant importance in the manufacture of cements and mortar products. The ultimate final product being cement and mortar, in which these raw materials are used, requires continuous manufacturing process improvements to reduce cost and application development to boost demand.

c. Production Scheduling

Procurement process for the raw material is based on prudently prepared sales forecasts. The procurement function and the ordering processes are looked after by the “materials department” of XYZ & Co. Factors like lead time, availability, negotiations, etc are taken into consideration.

d. Manufacturing

XYZ & Co manufactures the end product at its manufacturing locations in Country A, using its own process and product know-how and resources.

e. Inventory Management

XYZ & Co is responsible for managing the procurement of raw materials and maintaining the requisite stock levels for the production of the end product. XYZ & Co is also responsible for maintenance of inventory of the end product based on its assessment of demand-supply position in the market and forecast for the same.

f. Testing and Quality Control

Testing and quality control are critical processes in the manufacture and marketing of cement and mortar products in general as well as for the raw materials used in manufacturing of these products. XYZ & Co performs testing and quality control measures both for raw materials used and for the end products manufactured. Testing activity involves testing of raw materials and manufactured products against specified national and international quality standards and customer specifications.

g. Selling and Distribution Activities

The end products manufactured by XYZ & Co are sold by XYZ & Co directly to large customers and through distribution channels, mostly consisting of stockists and dealers spread all over Country A and globally.

h. Post Sales Activities

XYZ & Co handles post-sales activities related to final products manufactured by it, using the raw materials sourced from its associated enterprises. The post sales activities includes customer invoicing, meeting the performance guarantees and warranties, settling claims for damages, collection of customer payments, monitoring customer credit limits, follow-up for payments, taking appropriate measures and actions in the event of customer defaults.

2. Description of Functions Performed by the Associated Enterprise ABC & Co

In the context of the intra-group transaction of purchase of raw materials (crushed limestone and gravel) from associated enterprise ABC &

Co, the economically significant functions performed by ABC & Co can be summarized as follows:

Figure A.1: Business Process: Functions Performed (example)



a. Market Development

ABC & Co, engaged in quarrying, crushing and selling of crushed stone and gravel, needs to keep abreast of market trends and developments. Such activities include gathering relevant information on market, trends, availability of product substitutes, actions of competitors, development of product variations for additional applications, etc.

However, in the context of intra-group transaction with XYZ & Co, there are no substantial market development activities because limestone and gravels supplied to XYZ & Co are of a specified standard quality.

b. Process Improvement

ABC & Co undertakes R&D activities to improve the processes related to the quarrying and crushing to reduce the cost and improve operating margins.

c. Quarrying and Crushing

The quarrying and crushing process is done by ABC & Co at its mining locations in Country B.

d. Inventory Management

ABC & Co is responsible for managing the quarrying and crushing of raw materials for the production of crushed limestone and gravel and maintaining the requisite stock levels.

e. Testing and Quality Controls

Testing and quality controls are critical processes in the quarrying and crushing of limestone and gravel. ABC & Co performs testing and quality control measures. Testing activity involves temperature variation testing, testing of crushed limestone and gravel against standard crushed limestone and gravel, conformity with international product standards and technical specifications of customers, etc.

f. Sales and Marketing

ABC & Co has a sales and marketing team for the sale of crushed limestone and gravel.

However, selling and marketing efforts of ABC & Co are mainly focussed on third party customers and least on business with XYZ & Co, due to the ownership affiliation which ABC & Co enjoys with XYZ & Co.

g. Post Sales Activities

ABC & Co handles post sales activities related to its products. The post sales activities includes customer delivery, arranging for shipments, invoicing, settling claims for damages, collection of customer payments, monitoring customer credit limits, follow-up for payments, etc.

3. General Management Functions

The functions addressed below are common functions that are carried out by any business irrespective of their size and type. These functions are drivers of every business and are indispensable in the economic environment.

a. Corporate Strategy Determination

Generally, all policies within the group are determined by the management of the respective entity, which continuously monitors the economic environment surrounding the respective entity, assesses its strategic position within the industry and targets how to achieve its corporate objectives.

b. Finance, Accounting, Treasury and Legal Function

The management of the respective entity is responsible for managing the finance, treasury, legal and accounting functions. Respective entities are also responsible for all local statutory compliance.

c. Human Resource Management Function

The Human Resource (HR) function of respective entity is coordinated by its management, which is responsible for recruitment, development and training of personnel including the emolument structure.

AI.4.2.3. Assets Employed

Every business requires assets (tangible or intangible) without which it cannot carry out its activities. Intangibles play a significant role in the functioning of a business and are accordingly very important. An understanding of the assets employed and owned by associated enterprises to the transaction provides an insight into the resources deployed by them and their contribution to the relevant business processes/economic activities.

1. Tangible Assets

- a) The following routine tangible assets are employed by XYZ & Co at its manufacturing locations at which end products are manufactured using crushed limestone and gravel sourced from its associated enterprise:
 - Land and buildings;
 - Plant and machinery;
 - Traction lines and railway sidings;

- Water works;
- Furniture, fitting and office equipment;
- Vehicles; and
- Skilled, semi-skilled and unskilled work force.

In addition to the aforementioned manufacturing-related tangible assets, human resources and other tangible assets are deployed for market development, sales and marketing and corporate administration related to end products.

The following routine tangibles assets are owned by ABC & Co for its business as a whole:

- b) ABC & Co, being a mining entity, employs tangible assets and human resources similar to those employed by XYZ & CO, in relation to its business of quarrying and sale of limestone and gravel. In addition, it owns large-scale mines.

2. Intangibles

- a) XYZ & Co has been in the business of manufacture of cement and mortar for 30 years. Due to this experience, it has developed/acquired/built up many intangibles such as know-how, a brand name, goodwill, marketing expertise, skill and experience, networks, customer databases, etc. Although these intangibles cannot always be measured monetarily, they indirectly impact the business segment relevant to intra-group transaction under review.
- b) ABC & Co does not possess any non-routine intangible assets. Routine intangible assets possessed by it primarily include quarrying and crushing process know-how. ABC & Co is dependent on XYZ & Co for its major sales.

AI.4.2.4. Risk Analysis

Risk profiling of XYZ & Co and ABC & Co in relation to the intra-group transactions of purchase and sale of products is provided below:

Table A.13: Risk Profile (example)

Risk Category and Description	Exposure to XYZ & Co	Exposure to ABC & Co
Market Risk: Market risk arises for a business due to the uncertainty in the structure of the market, demand patterns and needs of customers, costs, pricing pressures etc. Market risk represents standard risk borne by any enterprise in market driven transactions.	XYZ & Co is exposed to this risk in respect of the end products.	ABC & Co is exposed to this risk in respect of its products and has a proportionate impact of exposure of XYZ & Co.
Product Liability Risk: Risks associated with product failures including non-performance to generally accepted or regulatory standards. This could result in product recalls and possible injuries to end users.	XYZ & Co is exposed to this risk in respect of the end products. However, this risk is mitigated due to the excellent quality, safety standards and processes used.	ABC & Co is exposed to this risk in respect of its products. However, this risk is mitigated due to the excellent quality, safety standards and processes used.
Technology Risk: This risk arises if the market in which an entity operates is sensitive to the introduction of new products and technologies. Hence, in that case, business units may face loss of potential revenues due to inefficiencies arising from obsolete infrastructure and tools as well as obsolescence of production processes.	XYZ & Co is exposed to this risk in respect of the end products.	ABC & Co is exposed to lesser risk as compared to XYZ & Co since limestone and gravels are natural minerals and the related quarrying processes does not require use of much sophisticated technology.
Research and Development Risk: Represents risk that R&D activities performed by an enterprise may not be successful and investment in R&D activity may be lost.	XYZ & Co is exposed to this risk in respect of the end products.	ABC & Co does not require much R&D, except those related to improvement in quarrying and crushing processes. Therefore, R&D risk exposure is to a lesser degree.
Credit Risk: This is the risk arising from non-payment of dues by customers.	XYZ & Co faces credit risk with respect to its sales of end products to third party customers.	ABC & Co is less exposed to this risk in respect of its transaction with XYZ & Co, on account of the associated enterprises relationship.

Risk Category and Description	Exposure to XYZ & Co	Exposure to ABC & Co
Inventory Risk: This risk is associated with management of inventory in case of overstocking or slow/non-moving inventory resulting from a rapidly changing technology/price sensitive market. As a result, the enterprise may be forced to bear a loss of margin on the inventory, or incur other additional costs to dispose of it.	XYZ & Co is exposed to this risk in respect of end products.	ABC & Co bears the risks associated with carrying inventory of mineral products including risk of quality deterioration.
Foreign Currency Risk: The risk arises from any adverse revaluation of assets and liabilities due to fluctuation in exchange rates, which would eventually have a negative impact on the profitability of the enterprise.	Since XYZ & Co has to make payments to ABC & Co in foreign currencies (mainly US\$), it is subject to the appreciation or depreciation of the domestic currency against the US\$.	Since ABC & Co exports its products to XYZ & Co, and invoices in US\$, it face foreign exchange risk because US\$ is not its functional currency.
Sourcing Risk: This risk arises from a demand/supply mismatch in critical inputs.	XYZ & Co is less exposed to this risk due to its special relationship with ABC & Co which is a source of strategic supplies of raw materials.	ABC & Co's products, being natural minerals, are subject to depletion and are non-reproducible. ABC & Co is substantially exposed to sourcing risk.

AI.4.2.5. Characterization

The FAR analysis for the intra-group transaction of purchase of products between XYZ & CO and its ABC & Co can be broadly summarized as follows:

Table A.14: Level of Risk (key to symbols used)

Symbol	Comparative Risk Level Standards	Comparative Functional Level Standards
-	Lowest exposure	Least functions
--	Medium exposure	Lesser functions
----	Highest exposure	Highest functions

Table A.15: Summary of Functions Assets and Risks Analysis (example)

Category	Level of Intensity	
	XYZ & Co	ABC & Co
Functions Performed	---	-
Market development	---	--
Product/Process development and improvement	---	---
Production planning and procurement	---	---
Inventory management	---	---
Manufacturing/Quarrying	---	---
Testing and quality control	---	---
Sales and marketing	---	-
Post sales activities	---	--
General Management Functions		
Corporate strategy determination	---	---
Finance, accounting, treasury and legal	---	---
Human resource management	---	---
Assets Employed		
Tangibles	---	---
Intangibles	---	-
Risks Assumed		
Market risk	---	--
Product liability risk	---	---
Technology risk	---	-
R&D risk	---	-
Credit risk	---	-
Inventory risk	---	---
Foreign currency risk	---	---
Sourcing risk	-	---

Based on the above FAR Analysis, the following conclusions can be deduced:

- a) Both ABC & Co and XYZ & Co are employing more or less similar assets (except intangibles) and carrying on similar functions related to products dealt with by them in the intra-group transaction under review.
- b) XYZ & Co is exposed to a higher risk in relation to its business than its associated enterprise, ABC & Co.

- c) However in terms of input sourcing risk and inventory risk, XYZ & Co is exposed to a lesser risk level on account of secured input supplies from ABC & Co.
- d) XYZ & Co is exposed to much higher risk in relation to technology, research and development and credit risk as compared to its associated enterprise ABC & Co which does not face such risk substantially.

AI.4.3. Economic Analysis

AI.4.3.1. Overview of Intra-group Transactions

XYZ & Co engaged in the following intra-group transactions with its associated enterprises ABC & Co:

Table A.16: Summary of Intra-group Transactions (*example*)

No.	Description of the Transactions	Amount
1	Purchase of raw material	
	Crushed limestone	--
	Gravel	--

AI.4.3.2. Selection of the Tested Party

In order to select the most appropriate method for determining the arm's length price or operating results, it is first necessary to select the "tested party". The tested party is the participant in a related party transaction whose prices (charged or paid) or whose profit margins will be tested using the most appropriate method. The tested party is ordinarily the party whose prices or profits can be verified using the most reliable data and requiring the fewest and most reliable adjustments and for which reliable data regarding uncontrolled comparables can be located. Based on an analysis, XYZ & Co has been selected as the tested party for the analysis of all the intra-group transactions listed in the table above.

In selection of XYZ & Co as the "tested party", we are guided by the following factors:

- The information about XYZ & Co is more easily and readily available and accessible;
- Similarly, the reliable information on comparable uncontrolled transactions can be obtained and verified in a relatively reliable manner in view of availability of internal comparable uncontrolled transactions. Therefore, the condition of reliability is achieved; and
- The available information also enables carrying out of reliable adjustments for material differences, if any.

AI.4.3.3. Selection of the Most Appropriate Method

The most appropriate method

The selection of the pricing method to be used to test the arm's length character of a controlled transaction must be made according to the "Most Appropriate Method".

The transfer pricing methods are analytical tools designed to test the arm's length character of transfer pricing results between controlled parties. No method is in itself right or wrong for any given set of facts and circumstances. Rather, the selection of the most appropriate pricing method to be used to determine the arm's length character of a controlled transaction is based on a determination of the method which, under the facts and circumstances of the transaction under review, provides the most reliable measure or best estimate of an arm's length result.

In determining the reliability of a method, the two most important factors to be taken into account are:

1. The degree of comparability between the controlled and uncontrolled transactions; and
2. The coverage and reliability of the available data. Other factors such as the nature and class of intra-group transactions, the extent and reliability of adjustments that can be made, and the extent and reliability of assumptions that may be required in applying the method, shall also be taken into account.

Because the selection of the most appropriate method involves a test of relative merit, a method that may not be perfect is not rejected unless some other method can be shown to be more reliable or provide a better estimate of an arm's length result.

AI.4.3.4. Evaluation of Alternative Pricing Methods

The method selected to determine the arm's length operating results of the tested party must be the one best suited to the facts and circumstances of each particular intra-group transaction and which provides the most reliable measure of the arm's length price.

The determination of the most appropriate transfer pricing method applicable for intra-group transactions of XYZ & Co and its application can be analysed as follows:

Purchase of Raw Materials: Crushed Limestone and Gravel

Rejected methods

For purposes of these intra-group transactions, the Resale Price Method (RPM), Cost Plus Method (CPM), the Profit Split Method (PSM) and the Transactional Net Margin Method (TNMM) have been rejected.

1. Resale Price Method:

The RPM is primarily intended to measure the value of the services performed by a buyer/reseller of goods acting as a distributor. Under the RPM, comparability is primarily dependent upon the similarity of functions performed and the risks assumed by the controlled and uncontrolled distributors. In this context, similarity of the tangible goods bought and resold would also be quite relevant. Moreover, the RPM focuses on the gross profit margins, which are heavily influenced by the scope and intensity of the functions performed. This is something that may vary widely among uncontrolled parties.

Since these international transactions of XYZ & Co do not resemble in any way the functions that a distributor

performs, the RPM is not an appropriate method to determine the arm's length results in these transactions.

2. Cost Plus Method:

The CPM is typically applied to test the price of goods that are manufactured using materials purchased from unrelated parties and then sold to related parties or to measure the value of services performed by a service provider. It is generally appropriate where the party being examined is engaged in significant value-adding activities. The CPM focuses on the gross profit margins, which are heavily influenced by the scope and intensity of the functions performed and accounting methods used and each of these may vary widely among enterprises. The computation of gross margins can be affected by the particular accounting conventions used by an enterprise to classify direct/indirect cost of goods produced or operating expenses, which might vary widely. Further, the application of the CPM requires a high level of comparability between the controlled transaction and the comparable uncontrolled transaction in terms of the intensity of functions performed and risks assumed, particularly in the level of operating expenses incurred. This again is subject to wide variation because the nature and mode of operations could be varied. For these reasons, the CPM was not considered to be an appropriate method for deriving an arm's length price.

3. Profit Split Method:

The PSM may be applicable when the various entities, involved in controlled transactions in which the associated enterprises are engaged, have significant intangible assets and/or operations of the entities are highly integrated, sharing more or less proportionately in the risks associated with the design, production and sale of applicable product that cannot be evaluated on a separate basis. Also, in general, the PSM relies primarily on internal data and assumptions pertaining to each party to the controlled transaction instead of relying on comparable uncontrolled transactions as market benchmarks, thus making the use of the PSM ordinarily less reliable than the other methods.

As the operations of XYZ & Co can be independently evaluated and there is availability of internal comparable uncontrolled transactions, the PSM is not considered to be an appropriate method to determine the arm's length results in these transactions.

4. Transactional Net Margin Method:

The TNMM tests the arm's length character of transfer prices in a controlled transaction by comparing the operating profits earned by the tested party in the transactions under examination to the operating profits earned by uncontrolled parties engaged in similar business activities. The expression "operating profit" means profit before interest, financial charges/losses and other non-operating expenses. Accordingly, the quantum of financial/non-operating expenses does not affect the transfer pricing analysis.

The TNMM measures the total return derived from the controlled taxpayer's most narrowly defined business activity for which reliable data incorporating the controlled transaction under review is available. The strength of the TNMM is that net margins (e.g. return on assets, operating income to sales and possibly other measures of net profit) are less affected by transactional differences. Also under TNMM, some functional diversity between the controlled and uncontrolled parties is acceptable.

However, the TNMM is generally applied if no other method is directly applicable for the given transaction. It is mostly used as a residual method. Hence, for the above transactions TNMM is not applied since the internal comparable uncontrolled price is available.

Selected Method

1. Comparable Uncontrolled Price Method:

The Comparable Uncontrolled Price (CUP) Method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

The CUP Method relies on comparability of actual per unit prices, while other methods rely on the comparability of profit margins. Profit margins tend to adjust automatically for differences between controlled and uncontrolled transactions that relate to the type and intensity of functions performed; per unit prices do not. The CUP Method requires a high degree of comparability between the products sold or services provided in the controlled and uncontrolled transactions.

The arm's length per unit prices to, or by, uncontrolled enterprises is substantially dependent upon factors such as volume, contractual terms, locational differences, business strategies, etc.

In practice, there are two types of comparable uncontrolled transactions. The first, known as an "internal comparable" is a transaction between one of the parties to the controlled transaction and an unrelated third party. The second, known as an "external comparable", is a transaction between two third parties, each unrelated to the parties engaged in the controlled transaction.

In view of the fact that the CUP Method is the most direct evidence of adherence to arm's length pricing and availability of internal comparable uncontrolled transactions in the context of these intra-group transactions of XYZ & Co, the CUP Method is selected as the most appropriate method for testing adherence to arm's length pricing for these international transactions.

AI.4.3.5. Application of Transfer Pricing Methods and Benchmarking

Application of the CUP Method for purchase of raw material from ABC & Co

The CUP Method is the most direct method of testing arm's length pricing given the facts and circumstances of the intra-group transactions of XYZ & Co under consideration and is relatively preferred over the profit-based methods. The intra-group transaction of purchase of raw material (crushed limestone and gravel) from associated enterprise ABC & Co is being benchmarked adopting the CUP Method for the following reasons:

- The transactions with independent uncontrolled suppliers meet the comparability tests with the controlled transactions;
- In addition to internal comparable uncontrolled transactions, external comparable price information is also available in the form of prices published by IJK International Group in its weekly magazines.

Accordingly, the CUP Method is selected for confirming the arm's length nature of XYZ & Co's transactions of purchase of raw material (crushed limestone and gravel) from its associated enterprise ABC & Co.

The CUP benchmarking has been done as follows:

1. External Comparables

External comparable prices have been derived from weekly reports published by the IJK Group of Country Z. IJK publications monitor world crushed limestone and gravel trade, markets and prices and has set the industry standard for providing timely, accurate and informative market intelligence. IJK uses a market appropriate methodology to assess prices in the markets it covers. IJK consults with the range of participants involved in different markets and publishes methodologies for each price report. Each methodology is reviewed regularly to ensure that it always meets the needs of market participants and is in line with industry practice. IJK seeks to reflect the way markets are traded, rather than impose its own view.

Table A.17: Comparative Table, Prices Charged for Crushed Limestone (example)

No	Product	Relevant Date	Price Charged by ABC & Co per metric ton (in \$)	Market Rate per metric ton as per IJK Publication (in \$)	Deviation, if any (in \$)
1	Crushed Limestone	08/04/20XX	2.30	2.15-2.30	-
2	Crushed Limestone	21/04/20XX	2.30	2.30	-
3	Crushed Limestone	06/05/20XX	2.30	2.30	-
4	Crushed Limestone	17/05/20XX	2.30	2.30	-
5	Crushed Limestone	06/06/20XX	2.30	2.30	-
6	Crushed Limestone	07/06/20XX	2.30	2.30	-
7	Crushed Limestone	19/06/20XX	2.30	2.30	-
8	Crushed Limestone	26/06/20XX	2.30	2.30	-
9	Crushed Limestone	29/06/20XX	2.30	2.30	-
10	Crushed Limestone	25/07/20XX	2.45	2.45	-

Table A.18: Comparative Table, Prices Charged for Gravel (example)

Sr. No	Product	Relevant Date	Price Charged by ABC & Co per Metric Ton (in \$)	Market Rate per metric ton as per IJK Publication (in \$)	Deviation, if any (in \$)
1	Gravel	08/04/20XX	1.30	1.15-1.30	-
2	Gravel	21/04/20XX	1.30	1.30	-
3	Gravel	06/05/20XX	1.30	1.30	-
4	Gravel	17/05/20XX	1.30	1.30	-
5	Gravel	06/06/20XX	1.30	1.30	-
6	Gravel	07/06/20XX	1.30	1.30	-
7	Gravel	19/06/20XX	1.30	1.30	-
8	Gravel	26/06/20XX	1.30	1.30	-
9	Gravel	29/06/20XX	1.30	1.30	-
10	Gravel	25/07/20XX	1.45	1.45	-

2. Internal Comparables

(A) During the year, XYZ & Co also purchased crushed limestone from an uncontrolled independent supplier namely, PQR & Co, under similar circumstances. The average price charged by PQR & Co to XYZ & CO for supply of crushed limestone is \$ 2.50 per metric ton (MT) FOB. The average Free on Board (FOB) price per metric ton paid to/charged by associated enterprise ABC & Co is \$ 2.315, which is lower than the price charged in the above international comparable uncontrolled transactions.

(B) During the year, XYZ & Co also purchased gravel from several uncontrolled independent suppliers under similar circumstances. The average price charged by them to XYZ & CO for supply of gravel is \$ 1.40/metric ton FOB. The average FOB price per MT paid to/charged by associated enterprise ABC & Co is \$ 1.315, which is lower than price charged in aforesaid international comparable uncontrolled transactions.

Having regard to comparable external uncontrolled prices and comparable internal uncontrolled prices, it is concluded that the international transaction of purchase of raw material (crushed limestone and gravel) from associated enterprise ABC & Co meets with arm's length pricing condition.

AI.4.4. Documentation

Information and documents to be kept and maintained by the taxpayer who has entered into an intra-group transaction are as follows:

No.	Particulars
1	A description of the ownership structure of the taxpayer with details of shares or other ownership interests held therein by other enterprises;
2	A profile of the multinational group of which the taxpayer is a part of along with the name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom intra-group transactions have been entered into by the taxpayer, and ownership linkages among them;
3	A broad description of the business of the taxpayer and the industry in which the taxpayer operates, and of the business of the associated enterprises with whom the taxpayer has transacted;
4	The nature and terms (including prices) of intra-group transactions entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction;
5	A description of the functions performed, risks assumed and assets employed or to be employed by the taxpayer and by the associated enterprises involved in the intra-group transaction;
6	A record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the taxpayer for the business as a whole and for each division or product separately, which may have a bearing on the intra-group transactions entered into by the taxpayer;
7	A record of uncontrolled transactions taken into account for analyzing their comparability with the intra-group transactions entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the intra-group transactions;
8	A record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant intra-group transaction;
9	A description of the methods considered for determining the arm's length price in relation to each intra-group transaction or class of transaction, the method selected as the most appropriate method along with explanations as to why such method was so selected, and how such method was applied in each case;

10	A record of the actual working carried out for determining the arm's length price, including details of the comparable data and financial information used in applying the most appropriate method. This should also address any adjustments made to account for differences between the intra-group transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions;
11	The assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price;
12	Details of the adjustments, if any, made to transfer prices to align them with arm's length prices determined under these rules and any consequent adjustment made to the taxable income for tax purposes;
13	Any other information, data or document, including information or data relating to the associated enterprise, which may be relevant for determination of the arm's length price;
14	Official publications, reports, studies and databases from the government of the country of residence of the associated enterprise, or of any other country;
15	Reports of market research studies carried out and technical publications brought out by institutions of national or international repute;
16	Price publications including stock exchange and commodity market quotations;
17	Published accounts and financial statements relating to the business affairs of the associated enterprises;
18	Agreements and contracts entered into with associated enterprises or with unrelated enterprises in respect of transactions similar to the intra-group transactions;
19	Letters and other correspondence documenting any terms negotiated between the taxpayer and the associated enterprise; and
20	Documents normally issued in connection with various transactions under the accounting practices followed.

Appendix II

PART A: EXAMPLE OF A DISCLOSURE FORM

Table A.20: Disclosure Form

TRANSFER PRICING DISCLOSURE FORM																			
This form provides a broad level disclosure of taxpayer's related party transaction(s) and the analysis performed to demonstrate compliance with arm's length principle. Please refer to the instruction sheet for completing this form																			
Section A – Basic Information																			
1 Name of the taxpayer	<input style="width: 100%; height: 20px;" type="text"/> <input style="width: 100%; height: 20px;" type="text"/>																		
2 Tax ID	<table border="1" style="width: 100%; height: 20px; border-collapse: collapse;"> <tr> <td style="width: 12.5%;"></td><td style="width: 12.5%;"></td><td style="width: 12.5%;"></td><td style="width: 12.5%;"></td><td style="width: 12.5%;"></td><td style="width: 12.5%;"></td><td style="width: 12.5%;"></td><td style="width: 12.5%;"></td><td style="width: 12.5%;"></td><td style="width: 12.5%;"></td><td style="width: 12.5%;"></td><td style="width: 12.5%;"></td><td style="width: 12.5%;"></td><td style="width: 12.5%;"></td><td style="width: 12.5%;"></td><td style="width: 12.5%;"></td> </tr> </table>																		
3 Address	<input style="width: 100%; height: 20px;" type="text"/> <input style="width: 100%; height: 20px;" type="text"/>																		
4 Country of residence	<input style="width: 100%; height: 20px;" type="text"/>																		
5 Fiscal year	<input style="width: 100%; height: 20px;" type="text"/>																		
6 Standard Industry Classification ('SIC') code of the taxpayer (<i>refer to instruction 1</i>)	<input style="width: 100%; height: 20px;" type="text"/> <input style="width: 100%; height: 20px;" type="text"/>																		
7 Brief business overview of the ultimate parent company (<i>refer to instruction 2</i>)	<input style="width: 100%; height: 40px;" type="text"/>																		
8 Brief business overview/functional profile of the taxpayer	<input style="width: 100%; height: 30px;" type="text"/>																		
9 Has there been any change in the functional profile of the taxpayer (<i>refer to instruction 3</i>)	<input type="checkbox"/> Yes <input type="checkbox"/> No																		
10 If yes, please provide an overview of the change in the functional profile (<i>refer to instruction 3</i>)	<input style="width: 100%; height: 40px;" type="text"/>																		
11 Gross revenue of the taxpayer for current year and immediately 2 preceding years (in local currency)(<i>refer instruction 4</i>)	Current year	Preceding year 1	Preceding year 2																
	<input style="width: 80%; height: 20px;" type="text"/>	<input style="width: 80%; height: 20px;" type="text"/>	<input style="width: 80%; height: 20px;" type="text"/>																
12 Has there been any change in the ownership structure of the taxpayer?	<input type="checkbox"/> Yes <input type="checkbox"/> No																		
13 If yes, please provide an overview of the change in the ownership structure	<input style="width: 100%; height: 30px;" type="text"/>																		

PART B: EXAMPLES OF COUNTRY RULES ON DOCUMENTATION

B.1 Republic of Korea¹

B.1.1. Reporting of the Method of Determining an Arm's Length Price to the Tax Authorities

A taxpayer should select the most reasonable method of determining an arm's length price in accordance with the criteria provided in the legislation and report the selected method and the reason for the selection to the district tax office at the time of filing a tax return.

When filing the tax return, the taxpayer entering into an international transaction with a related party overseas should submit to the district tax office a detailed statement of the international transaction specified in the Ministerial Decree (Form No.8) together with the simplified profit and loss statements or financial statements of the overseas related party.

This is not the case, however, if the total value of international transactions of goods and that of international transactions of services of the taxpayer for the taxable year concerned is 5 Billion Korean Won or less and 500 Million Korean Won or less, respectively.

B.1.2. Taxpayers' Obligation to Submit the Requested Information on International Transactions

The tax authorities may request a taxpayer to submit the relevant information necessary for applying the transfer pricing rules including the transfer pricing method used for determining the transaction price in question.

The information to be requested includes the following:

- Price list of the products;
- Various contracts regarding the transfer or purchase of properties;

¹Transfer pricing documentation is provided in the Law for Coordination of International Tax Affairs (LCITA) and its Enforcement Decrees.

- Details of manufacturing costs of the products;
- Details of transactions made with related and unrelated parties for each line of products;
- In the case of the supply of services or other types of transactions, the documents similar to those listed above;
- Organization chart and job description of the relevant corporations;
- Data used for the determination of international transaction prices;
- Price determination policy between and among related parties;
- Accounting standards and methods related to the transactions in question;
- Details of business activities performed by the parties connected to the transaction in question;
- Ownership relations among the related parties;
- Forms or items not submitted to the district tax office in filing tax returns; and
- Other data necessary for computing an arm's length price.

The above data must be prepared and submitted in Korean. However, they can be prepared and submitted in English if the tax authority permits it.

A taxpayer who is requested to submit information should submit such information within 60 days of the date the request is received. However, if the taxpayer files an application for an extension of the due date with a justifiable reason as prescribed by the Enforcement Decree, the tax authorities may allow an extension for up to 60 days.

B.1.3. Sanctions Against Non-compliance with the Request for Submission of Information

If a taxpayer who is requested to submit information fails to submit the requested information by the due date without a justifiable reason, and instead submits the information at a later stage when filing a tax appeal or in the course of a Mutual Agreement Procedure provided in

a tax treaty, the tax authority or other related authorities may decide not to use such documents as evidence for taxation purposes.

If a taxpayer who is requested to submit information fails to submit the requested information by the due date without a justifiable reason, the taxpayer shall be subject to a fine for negligence up to an amount of 100 Million Won.

B.1.4. Exemption from Under-reporting Penalty in Case of Contemporaneous Documentation

Tax authorities should not impose a penalty for the under-reporting of income (10 per cent of the additional tax amount due) if it is confirmed through competent authorities' mutual agreement procedures that the taxpayer was not at fault with regard to the difference between the reported transaction price and the arm's length price. It shall not be deemed that the taxpayer was at fault if the following conditions are met:

- The taxpayer presents the procedure through which the most reasonable method was selected, out of the methods of determining an arm's length price, with documentation prepared at the time of filing tax return;
- The taxpayer actually used the selected method; and
- The taxpayer has kept necessary data and information related to the selected method.

Tax authorities should not impose a penalty for the under-reporting of income (10 per cent of the additional tax amount due) if a taxpayer has prepared and maintained contemporaneous transfer pricing documentation for the transfer pricing methods applied to the cross-border inter-company transactions reported in the corporate income tax return, and such documentation substantiates the reasonableness of the selected methods and the application thereof. A taxpayer shall prepare and maintain the following documentation at the time of reporting corporate or income tax and submit it within 30 days upon request by the relevant tax authorities:

- Outline of the business (including an analysis of factors influencing prices of its assets and services);

- Business organizational chart (illustrating related parties to which transfer pricing may be applicable); and
- Documents illustrating the process by which the applied transfer pricing method was selected:
 - Economic analysis and projections that served as the basis for selecting the particular method;
 - Documents describing the details of adjustments made in determining the arm's length price range using comparables data;
 - Alternative transfer pricing methods and the reasons why those were not selected; and
 - Relevant documents covering the time period from the end of the taxable period until the filing of the tax returns.

Criteria applied in determining the above mentioned "reasonableness" are as follows:

- With the end of the concerned taxable period as the basis, whether the collected data on the comparables are adequately representative. Particularly, it should be examined whether an omission of data of a certain comparable led to an outcome advantageous to the taxpayer;
- Whether the selection and application of the concerned transfer pricing method is supported by systematic analysis of the collected data; and
- If a certain transfer pricing method was agreed upon through an APA process in a prior taxable year or was selected by the tax authorities during an audit, whether there are reasonable grounds for applying or not applying the said transfer pricing method for the relevant taxable year.

B.2. India

B.2.1. Documentation to be Maintained

Sec. 92D of the Finance Act read with Rule 10D(1) of the Income Tax (IT) Rules lays down thirteen different types of information/

documents that a person, entering into international transactions with associated enterprises, is required to maintain. Broadly, the information or documents can be classified as:

- Enterprise-related documents;
- Transaction-specific documents; and
- Computation related documents.

B.2.2. Enterprise-related Documents

These documents describe the enterprise, the relationship with other associated enterprises, the nature of business carried out, etc. This information is largely descriptive (Clauses (a) to (c) of Rule 10D(1) of the IT Rules). An illustrative list of information/documents to be maintained under this classification follows:

- Ownership/shareholding pattern of the taxpayer;
- Business profile of the multinational group;
- Details of associated enterprise(s) with which international transactions are entered into;
- Business of the taxpayer and the associated enterprise(s); and
- Broad industry profile in which the taxpayer operates.

The above documentation would provide the tax authorities with preliminary information as to the taxpayer's group profile, function in the group and the industry in which it operates. The broad industry profile, if well documented, will provide the tax authorities with an overview of the demand and the business drivers within the industry as well as the taxpayer's position in the industry. The documentation can also provide an overview of the taxpayer's growth objectives, given the evaluation of the industry sector and the competitive dynamics within the industry in which the taxpayer operates.

B.2.3. Transaction-specific documents

These documents explain each international transaction in detail e.g. the nature and terms of contracts, description of the functions performed, assets employed and risks assumed by each party to the

transaction, economic and market analyses, etc. (Clauses (d) to (h) of Rule 10D(1) of the IT Rules). An illustrative list of information/documents to be maintained under this classification follows:

- Details of each international transaction e.g. name of the associated enterprise, product transferred/service provided, quantity, price, shipment and credit terms, etc;
- Functional analysis of the taxpayer and associated enterprise(s) listing the functions performed, assets employed and risks assumed for undertaking the international transaction;
- Pricing policy adopted for the international transaction;
- Budget/forecasts for the taxpayer's business;
- Reports of market research studies carried out and technical publications brought out by institutions of national or international repute;
- Record of uncontrolled transactions (internal and external comparables) for each international transaction including nature and terms of the uncontrolled transactions; and
- Economic analysis to provide details of data used and data rejected with reasons thereof.

The above information would capture the relevant information about the taxpayer and the concerned associated enterprise(s). The documentation of the precise functions performed by the parties (taxpayer and associated enterprise) and the economic characterization (e.g. integrated manufacturer, contract manufacturer, indenting agent, support service provider, etc) of the respective parties would be relevant here. The economic characterization of parties would assist the taxpayer to determine the tested party.

In case the foreign associated enterprise is considered as the tested party for a particular international transaction, the relevant documents regarding the foreign associated enterprise should be maintained. The Indian Income Tax Appellate Tribunal in the case of *Ranbaxy Laboratories Ltd.*² observed that if a taxpayer wishes to take

²*Ranbaxy Laboratories Ltd. versus Additional Commissioner of Income Tax*, 2008 299 ITR 175 Delhi; (2008) 114 TTJ Delhi 1.

a foreign associated enterprise as the tested party it must ensure that the relevant data for comparison is available in the public domain or is furnished to the tax administration.

B.2.4. Computation-related Documents

These documents detail the methods considered, actual working assumptions, adjustments made to the transfer prices and any other relevant information/data relied on for determining the arm's length price **(Clauses (i) to (m) of Rule 10D(1) of the IT Rules)**.

An illustrative list of information/documents to be maintained under this classification follows:

- Nature of each international transaction and the rationale for selecting the most appropriate method for each international transaction. The taxpayer is required to substantiate the selection by proper documentation and also the manner in which the method was applied to each international transaction;
- Actual working/computation of the arm length's price i.e. recording the calculations performed to determine whether or not uncontrolled transactions are comparable to the international transactions with reasons for adjustments made to make the comparability analysis more reliable;
- Critical factors and assumptions influencing the determination of the arm's length price;
- Adjustments made (along with reasons) to the taxpayer's transfer prices so as to align it with the arm's length price; and
- Any other information relevant for the determination of the arm's length price.

One of the aspects of documentation is to capture the group policies and the pricing methodology of the international transaction. For instance, pricing methodology could be either on cost plus mark-up basis, percentage of sales basis, bilateral negotiations basis, etc to appropriately substantiate the arm's length nature of the transaction.

B.2.5. Contemporaneous Documentation

Rule 10D(4) of the IT Rules requires that the information and documents maintained by a taxpayer to demonstrate that the transaction price meets with the arm's length principle should be contemporaneous to the extent possible and should exist at the latest by the due date for filing the return of income.

A question that arises is what is meant by contemporaneous documentation. The Oxford English Dictionary defines the term "contemporaneous" as "*existing or occurring in the same period of time*". On such an approach, the contemporaneous documentation can be documentation that:

- Exists or is brought into existence at the time (by the due date for filing the return of income) the taxpayer is developing or implementing any arrangement that might raise transfer pricing issues; and
- Records all relevant information that was necessary for the management to make transfer pricing decisions. The documentation may be electronic or in written form, which includes books, records, contracts, studies, periodic activity reports, budgets, plans, projections, analysis, conclusion and other material.

Further, contemporaneous documentation maintained should have the following characteristics:

- Completeness;
- Accuracy, i.e. true and proper information; and
- Timeliness, i.e. information is maintained as and when the international transactions take place. This may not always be possible to comply with, e.g., when subsequent benchmarking under the Transactional Net Margin Method alone would show whether or not the international transactions have been carried out at prices which have yielded an arm's length margin.

Transfer pricing documentation is generated at various stages. For example, there could be the documentation which is maintained by a taxpayer as part of its ordinary business operations and used by it

to set the prices (e.g. in case of cost plus based pricing, definition of "costs") of its international dealings with associated enterprise(s) (e.g. invoices, orders, etc). Another form of documentation could be the one which is maintained by the taxpayer for establishing whether such prices comply with the arm's length principle.

India's Transfer Pricing Regulations (TPR), for example, do not clearly provide what is the nature of documentation to be maintained for each international transaction. Further, the TPR do not distinguish between the different nature of transactions for the purpose of maintaining documentation, i.e. the normal transactions and the transactions in exceptional circumstances e.g. market penetration, distress sale, pricing strategy, etc. In such cases, the taxpayer should endeavour, as far as possible, to record all relevant information (such as is available at the time of entering into the international transaction) that is critical for the management to determine the pricing/other factors of the international transaction. The information/documents maintained could be in the form of minutes of Board of Directors meetings, emails, faxes, agreements, quotations, independent valuations, market surveys, etc.

The following paragraphs illustrate the documentation to be maintained while entering into certain exceptional transactions such as market penetration and distress sales. However, specific information and documentation may vary in each case depending on the type of business and size of business operations of the enterprise.

B.2.6. Documenting Market Penetration Strategies

Market penetration is a business strategy which involves reduction in current profits in anticipation of an increase in future profits. The key element here is to analyse whether a third party would be prepared to trade-off its current profits in expectation of increased future profits under the same or similar conditions.

Hence, if a taxpayer intends to implement such a strategy, it is imperative on its part to document all the key facts and circumstances under which such a strategy is implemented and how the implementation of such a strategy accords with the arm's length principle. Documents for this purpose could be a market feasibility report, a document highlighting the broad outline of the strategy, benefits sought to be

achieved, future profitability, expected outcome and budgets that would demonstrate assumptions taken in adopting this strategy, etc.

B.2.7. Documenting “Distress Sales”

A distress sale is a forced sale of an asset or investment at a significantly reduced price because of a certain necessity or crisis.

To illustrate, a project office which is abruptly closing down sells its assets to group companies. In cases of a distress sale, the documentation for such a transaction should demonstrate the rationale behind the distress sale and the justification on how the international transaction accords with the arm’s length principle. Documents for this purpose could be the minutes of a Board of Directors meeting or shareholder meetings, government approvals, market survey reports or asset valuation reports, etc.

B.2.8. Documenting Receipt of Intra-group Services

An intra-group service is a service performed by one member of an MNE for the benefit of one or more other members of the group. The services performed can be of an administrative, technical, financial or commercial nature and may include management, coordination and control functions for the entire group. The key element here in analyzing the arm’s length nature of intra-group services would be whether an independent enterprise (service recipient) in similar circumstances would have been willing to pay for or perform such services itself. Group strategy or compliance process requirements may lead to sourcing intra-group services internally at higher cost than from an unrelated party, but such party would not have the same standards, which becomes a difficult factor to value. This is not an uncommon challenge in group services.

The documentation for such a transaction (from a service recipient perspective) should demonstrate actual receipt of services and the benefits derived from those services. The benefits received may be quantified to the extent possible. Documentation for this purpose could be minutes of meetings and telephone calls, detailed descriptions of the benefits received demonstrated by way of correspondence, memoranda, manuals, etc. Further, a certificate from an independent accountant of the

service providing entity may be obtained certifying the method of allocation of costs and authenticity of the cost apportioned to each entity. It may also be beneficial to document that the services could not have been rendered internally (by the service recipient) or by third parties.

B.2.9. Documenting Reimbursement/Recovery of Expenses

In certain circumstances one of the associated enterprises (Company X) incurs routine expenditure (e.g.: travel, hotel, freight, courier charges etc.) on behalf of another associated enterprise (Company Y). The primary liability to incur the expenditure and make payments to the concerned third party vendors is that of Company Y and it is purely for administrative convenience that the payment is made by Company X and subsequently recovered from Company Y (without any mark-up).

The parties to the transaction should maintain internal documentation such as internal memos, email correspondence, etc to demonstrate that the expenses were disbursed by Company X on behalf of Company Y and that all such expenses has been duly recovered.

The invoices raised by the third party vendors on Company X would form part of the documentation to substantiate that Company X has recovered the entire amount (at cost) from Company Y.

To the extent possible, one should attempt to maintain transfer pricing documentation at the time of entering into the international transaction. Further, in any case, the documentation should exist at latest by the due date for filing the tax return.

B.2.10. Need for Fresh Documentation

A proviso to Rule 10D(4) of the IT Rules requires that if an international transaction continues to have effect over more than one previous year, fresh documentation need not be maintained separately in respect of each year, unless there is any significant change in the following:

- Nature or terms of the international transaction; or
- Assumptions made; or
- Any other factor which would influence the transfer price.

However, if there has been a significant change in any of the above, fresh documentation is needed that brings out the impact of the above change on the pricing of the international transaction.

It is therefore important for each taxpayer to scrutinize, on a yearly basis, whether any fresh documentation is required to be maintained for any continuing transaction.

B.3. Nigeria

Nigeria's tax laws provide for documents to be provided to the Federal Inland Revenue Service (the Service) with this documentation forming the basis for the transfer pricing documentation. The law allows regulations to prescribe the type of documentation that can be demanded from companies. Some of the documentation required, which is applicable to both corporations and individuals, is noted below in relation to relevant legislation:

B.3.1. Companies Income Tax Act

Article 55: Returns and provisional accounts

1. Every company including a company granted exemption from incorporation shall, whether or not a company is liable to pay tax under this Act for a year of assessment, with or without notice from the Service, file a self-assessment return with the Service in the prescribed form at least once a year and such return shall contain –
 - a) the audited accounts, tax and capital allowances computation for the year of assessment and a true and correct statement in writing containing the amount of profit from each and every source computed;
 - b) a duly completed self-assessment form as may be prescribed by the Service, from time to time, attested to by a director or secretary of the company and such attestation shall contain a declaration that it contains a true and correct statement of the amount of its profits computed in respect of all sources in accordance with this Act and any rule made and that the particulars given in such return are true and complete; and

- c) evidence of payment of the whole or part of the tax due into a bank designated for the collection of the tax.

Article 58: Board may call for further returns

The Board may give notice in writing to any company when and as often as it thinks necessary requiring it to deliver within a reasonable time specified by such notice fuller or further returns respecting any matter as to which a return is required or prescribed by this Act.

Article 60: Call for returns, books, documentation and information

- (1) For the purpose of obtaining full information in respect of the profits within the time specified by the notice to any person the Service shall give notice to that person requiring him to –
 - (a) complete and deliver to the Service any return specified in such notice;
 - (b) appear personally before an officer or the Service for examination with respect to any matter relating to such profits or income;
 - (c) produce or cause to be produced for examination books, documents and any other information at the place and time stated in the notice which, time may be from day-to-day, for such period as the Service may deem necessary; or
 - (d) give orally or in writing any other information including name and address specified in such notice.
- (2) For the purpose of subsection (1) (a) to (d) of this section, the time specified by such notice shall not be less than seven days from the date of service of such notice, except that an officer of the Service not below the rank of a chief inspector of taxes or its equivalent may act in any of the cases stipulated in subsection (1) (a) to (d) of this section, without giving any of the required notices set out in this section.
- (3) A person who contravenes the provisions of this section commit an offence and shall, in respect of each offence, be

liable on conviction to a fine equivalent to the amount of the tax liability in addition to paying the tax due.

- (4) Nothing in this section or in any other provision of this Act shall be construed as precluding the Service from verifying by tax audit or investigation into any matter relating to any return or entry in any book, document, accounts, including those stored in a computer, digital, magnetic, optical or electronic media as may, from time to time, be specified in any guideline by the Service.
- (5) Any person may apply in writing to the Service for an extension of time within which to comply with the provisions of this section and section 10 of this Act, provided that the person –
 - (a) makes the application before the expiration of the time stipulated in this section for making the returns; and
 - (b) shows good cause for his inability to comply with this provision.
- (6) If the Service is satisfied with the cause shown in the application of subsection (5) (b) of this section, it may in writing grant the extension of the time or limit the time as it may consider appropriate.

B.3.2. Federal Inland Revenue Service (Establishment) Act

Article 28: Information to be delivered by bankers

- (1) Without prejudice to section 26 of this Act, every bank shall prepare upon demand by the Service, quarterly returns specifying –
 - (a) in the case of an Individual, all transactions involving the sum of N5,000,000.000 and above; or
 - (b) in the case of a body corporate, all transactions involving the sum of N10,000,000.000 and above, the names and addresses of all customers of the bank connected with the transaction and deliver the returns to the Service;
 - (c) the names and addresses of new customers of the bank and shall not later than the seventh day of the succeeding month deliver the returns to the Service.

- (2) Subject to subsection (1) of this section, for the purpose of obtaining information relative to taxation, the Service may give notice to any person including a person engaged in banking business in Nigeria to provide within the time stipulated in the notice, information including the name and address of any person specified in the notice:

Provided that a person engaged in banking business in Nigeria, shall not be required to disclose any additional information about his customer or his bank under this section unless such additional disclosure is required by a notice signed by the Executive Chairman of the Service on the advice of the Technical Committee of the Board.

- (3) Any bank that contravenes the provision of this section commits an offence and shall, on conviction be liable to a fine not exceeding N500,000.000 on corporate customers and not exceeding N50,000.00 in the case of individual customer.

GLOSSARY

Adjustments See Transfer Pricing Adjustment.

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

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

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

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

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

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

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

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

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

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

Berry Ratio The ratio of gross income to operating costs, sometimes used to establish the arm's length price using the Transactional Net Margin Method.

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

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

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

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

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

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

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

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

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

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

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

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

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

Competent Authority Procedure Under a double taxation treaty or other agreement the contracting states may each appoint a Competent Authority that is empowered to resolve disputes

arising from the interpretation or application of the agreement. This Mutual Agreement Procedure is provided for in the treaty or in another agreement such as the EU Arbitration Convention (Convention 90/436/EEC on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises).

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

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

Contribution Analysis Where the Profit Split Method is used, the contribution analysis requires the combined profit to be divided between the associated enterprises based on the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions.

Control Control is essentially defined for the purpose of Article 9 of the UN Model Double Tax Convention as a situation where one enterprise participates directly or indirectly in the management, capital or control of another; or where the same persons participate directly or indirectly in the management, capital or control of both enterprises.

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

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

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

Correlative Adjustment See Corresponding Adjustment.

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

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

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

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

Country-specific File Under the EU Code of Conduct on Transfer Pricing Documentation, taxpayers are recommended to keep documentation, including a country-specific file. This should contain a detailed description of the taxpayer's business strategy, details of country-specific controlled transactions, a comparability analysis, selection and application of a transfer pricing method, internal and external comparables etc.

Direct Charge Method A method of directly charging each recipient of intra-group services on a clearly identified basis, not involving apportionment of costs between recipients based on an allocation key.

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

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

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

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

Global Formulary Apportionment (GFA) A method with which to allocate the global profits of an MNE group amongst the associated enterprises on the basis of a multi-factor weighted formula. Possible factors are property, payroll and sales or other factors that may be defined while adopting the formula.

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

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

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

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

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

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

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

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

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

Joint International Tax Shelter Information Centre (JITSIC) The Joint International Tax Shelter Information Centre was set up in 2004 as a joint task force to identify and curb abusive tax transactions. The current member states are Australia, Canada, Japan, United Kingdom, the United States, the Republic of Korea and China. Two countries, France and Germany, have observer status.

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

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

Masterfile The EU Code of Conduct on Transfer Pricing Documentation recommends that the documentation of a multinational enterprise consists of two main parts, a master file and a country-specific file. The masterfile contains common standardized information relevant for all EU group members.

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

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

Mutual Agreement Procedure (MAP) A procedure by which the competent authorities of contracting states consult with a view to resolving disputes over the application of double

taxation treaties. This procedure may be used to eliminate double taxation arising from a transfer pricing dispute.

OECD Transfer Pricing Guidelines Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations from the Organisation for Economic Co-operation and Development (OECD). The guidelines are regularly updated.

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

Operating Margin (OM) Operating profit divided by sales.

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

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

Profit Split Method The Profit Split Method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions.

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

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

Resale Price Method (RPM) The Resale Price Method analyses the price of a product that a related sales company charges to an unrelated customer, i.e. the resale price, to determine an arm's length gross margin that the sales company retains to

cover its sales, general and administrative expenses and still make an appropriate profit. The remainder of the product's price is regarded as the arm's length price for the transactions between the sales company and a related party.

Residual Profit Split Under a residual profit split analysis the combined profits from the controlled transactions are allocated between the associated enterprises based on a two-step approach. In the first step sufficient profit is allocated to each enterprise to provide basic arm's length compensation for routine contributions. In the second step, the residual profit is allocated between the enterprises based on the facts and circumstances.

Return on Assets (ROA) Operating profit divided by the operating assets (normally only tangible assets).

Return on Capital Employed (ROCE) Operating profit divided by capital employed which is usually computed as the total assets minus cash and investments.

Return on Cost of Goods Sold Gross profit divided by cost of goods sold.

Return on Total Cost (ROTC) Operating profit divided by total costs

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

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

Safe Harbour A safe harbour in a transfer pricing regime is a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules. A safe harbour substitutes simpler obligations for those under the general transfer pricing regime.

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

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

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

Tested Party The tested party is the party in relation to which a financial indicator (e.g. mark-up on cost, gross margin or net profit) is tested when using the Cost Plus Method, Resale Price Method or Transactional Net Margin Method.

Thin capitalization A company is said to be "thinly capitalized" when it has a high proportion of debt capital in relation to its equity capital. The two most common tests for determining whether this ratio is too high are, firstly, by reference to the arm's length principle and, secondly, by reference to a fixed ratio of debt to equity. Many countries have rules designed to discourage thin capitalization, particularly in an international context. Excessive debt funding of companies from abroad is often viewed as leading to an unacceptable erosion of a country's revenue base.

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

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

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

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

Transfer Pricing Method A transfer pricing method is a methodology by which the arm's length principle is applied to determine the arm's length price of a transaction. Examples of transfer pricing methods are the Comparable Uncontrolled Price Method, Resale Price Method, Cost Plus Method, Transactional Net Margin Method and the Profit Split Method. Other appropriate methods are also used in some jurisdictions.

Uncontrolled Transaction A transaction between independent and unrelated enterprises.



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