

Background Paper

Working Draft

Chapter 1

An Introduction to Transfer Pricing

[This paper is essentially a paper prepared by Members of the UN Tax Committee's Subcommittee on Practical Transfer Pricing Issues, but includes some Secretariat drafting and suggestions not yet considered by them – the Secretariat takes responsibility for any relevant errors and omissions.]

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1. What is Transfer Pricing?

1.1 This introductory chapter intends to give a brief outline of the subject of transfer pricing and addresses the practical issues and concerns surrounding it, especially issues faced by, and approaches taken by, developing countries. Many of the issues discussed in the introduction are dealt with in greater detail in later chapters.

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.

1.3 The fact is that 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 a 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.

1.4 Furthermore 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.

1.5 The structure of transactions within an MNE group (the component parts of which, such as companies, are also called “associated enterprises” in the language of transfer pricing) is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. Thus, a large and growing number of international transactions are no longer governed entirely by market forces, but by forces which are driven by the common interests of the entities of a group.

1.6 In such a situation, it becomes important to establish the right price, called the “transfer price”, for intra-group, cross-border transfer of goods, intangibles and services. Transfer pricing is the general term for the pricing of cross-border, intra-firm transactions between related parties. “Transfer pricing” therefore refers to the setting of prices at which transactions occur involving the transfer of property or services between associated enterprises, forming part of an MNE group. These transactions are also referred to as “controlled” transactions, as distinct from “uncontrolled” transactions between companies that, for example, are not associated and can be assumed to operate independently (“on an arm’s length basis”) in reaching terms for such transactions.

1.7 It follows that, with the need to set such prices being a normal incident of how MNEs must operate, “transfer pricing” by itself does not necessarily involve tax avoidance. It is where the pricing does not accord with applicable norms internationally or at domestic law that we are entering into areas more properly called “mispricing”, “incorrect pricing”, “unjustified

pricing” or similar, and where issues of tax avoidance and evasion may arise. A few examples illustrate these points:

- Consider a profitable computer group in country A that buys “flash-memory drives” from its own subsidiary in country B: how much the parent country A company pays its subsidiary country B company (the “transfer price”) will determine how much profit the country B unit reports and how much local tax it pays. If the parent pays below normal market prices, 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 flash-memory drives from an independent company in country B it would pay the market price, and the supplier would pay taxes on its own profits in the normal way. This approach gives scope for the parent or subsidiary, whichever is in a low-tax jurisdiction, to be shown making a higher profit by fixing the transfer price appropriately and thereby minimising its tax incidence.
- So, when the various parts of the organisation 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 (an issue discussed further below) needs to be arrived at.
- Consider next the example of a high-end watch manufacturer in country A that distributes its watches through a subsidiary in country B. Let us say the watch costs \$1400 to make and it costs the country B subsidiary \$100 to distribute it. The company sets a transfer price of \$1500 and the subsidiary unit 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 is not showing any profit: the \$1500 transfer price plus the country B unit’s \$100 distribution costs are exactly equal to the \$1600 retail price. The country B’s tax administration wants the transfer price to be shown as \$1400 so that the country B’s unit shows the group’s \$100 profit that would be liable for tax.
- However 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 group it is liable for tax in the countries where it operates and in dealing with two different tax authorities it is not possible to just cancel one out against the other. Nor should it be

made to pay the tax twice. So, the MNE can end up suffering double taxation on the same profits where there are differences about what constitutes “proper” transfer pricing.

1.8 The economic reason for associated entities charging transfer prices for intra-group trade is to be able to measure the performance of the individual entities in a multinational group. The individual entities within a multinational company group are separate profit centres and transfer prices are required to determine the profitability of the entities. 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 price which two unrelated parties would agree to a transaction.

1.9 Though the above explanation of transfer pricing sounds logical and innocuous, arriving at a “proper” transfer price is a complex task because of the difficulty in identifying intangibles and services which were transferred or provided and the price at which they are to be valued. 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. Sometimes such intangibles are reflected in the accounts and sometimes not. Thus, there are many complexities involved which have to be taken into account while dealing with transfer pricing in cross-border transactions between MNE entities.

1.10 Transfer pricing is an economics term so it should be useful to see how economists define it - in business economics a transfer price is considered as the amount that is charged by a part or segment of an organisation for a product or service that it supplies to another part or segment of the same organisation.

2. Basic issues underlying Transfer Pricing

2.1 Transfer prices serve to determine the income of both parties involved in the cross-border transaction. The transfer price therefore tends to shape the tax base of the countries involved in cross-border transaction.

2.2 In any cross-border tax scenario, the three parties involved are the multinational group, taken as a whole, along with the tax authorities of the two countries involved in the transaction. When one country’s tax authority taxes a unit of the MNE group, it has an effect on the tax base of the other country. In other words, cross-border tax situations involve issues related to jurisdiction, allocation and valuation.

(i) Jurisdictional issues

2.3 Which government should tax the MNE’s income and what if both claim the same right? If we consider the case where the tax base arises in more than one country, should one of the

governments give tax relief to prevent double taxation of the MNE's income, and if so, which one? These are some of the jurisdictional issues which arise with cross-border transactions.

2.4 An added dimension to the jurisdictional issue is the spectre of transfer pricing manipulation as some MNEs engage in practices that seek to reduce their overall tax bills. This may involve profit shifting through transfer pricing in order to reduce the aggregate tax burden of a multinational group. It must be noted that the aim of reducing taxation may be a key motive influencing an international enterprise in the setting of transfer prices for intra-group transactions, but it is not the only factor contributing to the transfer pricing policies and practices of an international enterprise.

2.5 The aim in such cases is to usually reduce a multinational group's worldwide taxation 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. The net result is to maximise an international enterprise's after tax profits. For example, if an international enterprise has a tax rate in the residence country of the parent company of 30% and it has a subsidiary entity resident in another country with a tax rate of 20%, the parent has an incentive to shift profits to its subsidiary to reduce its tax rate on these amounts from 30% to 20%. If the parent company shifts \$100 million of taxable profits to its subsidiary, it will make a tax saving of \$10 million. This may be achieved by the parent being over-charged for the acquisition of property and services from its subsidiary.

2.6 While the most obvious motivation maybe to reduce an international enterprise's worldwide taxation, other factors may create an inducement for transfer pricing manipulation, such as imputation tax benefits in the parent company's country of residence.

2.7 Another motivation for an international enterprise 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.

2.8 In short, international taxation, especially transfer pricing related issues, throws open a host of issues, the complexity and magnitude of which are often especially daunting for smaller administrations.

(ii) Allocation issues

2.9 MNEs are global entities which share common resources and overheads. From the perspective of the MNE, these resources need to be allocated with maximum efficiency in the most optimal manner.

2.10 From the governments' perspective, the allocation of costs and income from the MNE resources needs to be addressed to calculate the tax. There sometimes tends to be a "tug-of-war" between countries in the allocation of costs and resources aimed towards maximising the tax base in their respective nation states.

2.11 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 for the MNEs cannot be disentangled from the global income of the MNEs for tax purposes – this is especially true in the case of intangibles and service-related intra-group transactions.

(iii) Valuation issues

2.12 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*. This directly leads us to a key issue of transfer pricing, the valuation of intra-firm transfers.

2.13 With the MNE being an integrated entity with the ability to exploit international differentials and utilise economies of integration not available to domestic firms, transfer prices within the group are unlikely to be the same prices unrelated parties would negotiate.

2.14 More generally speaking there sometimes seems to be an underlying tension between the common goals of the MNEs and the overall economic and social goals of countries. This is because the perceived responsibility of business is often seen as using its resources to increase its profits as much as possible while staying within the rules. This seems to be in contrast at times with the social, economic and political consideration of countries. With so many complex forces at play, it is clear why international taxation is an open-ended problem with transfer pricing at its heart.

2.15 In short, transfer pricing regulations are essential for countries in order to protect their tax base, to eliminate double taxation and to enhance cross border trade. For developing countries, to provide a climate of certainty and environment for increased cross-border trade while at the same time not losing out on critical tax revenue is of paramount importance and hence detailed transfer pricing regulations are a must.

3. Evolution of Transfer Pricing

3.1 This section aims to trace the history and the reasons for transfer pricing taxation regimes. First and foremost, an important aspect of transfer pricing to be kept in mind is that it involves economic principles being applied to a fluid marketplace. Thus new approaches and techniques to arrive at the "right" transfer price from the perspective of one or more actors in the system are constantly being evolved.

3.2 The OECD Guidelines, published in 1995 represents a consensus among OECD Member countries, mostly developed countries, and have largely been followed in domestic transfer

pricing regulations Another transfer pricing framework of note which has evolved over time is the USA Transfer Pricing Regulations (26 USC 482) .

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

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

3.6 Parent companies of large MNE groups usually have intermediary or sub-holdings in several countries around the world; research and development (“R&D”) and services may be concentrated in centres operating for the whole group or specific parts of the group. Intangibles, developed by entities of the MNE group, may be concentrated around certain group members; finance and “captive insurance companies” (insurance companies within a group having the specific objective of insuring group risks) may operate as insurers or internal banks; production of the assembly of final products may take place in many countries around the world. From a management perspective, the decision-making in MNE groups may range from highly centralised structures to highly decentralised structures with profit responsibility allocated to individual group members.

3.7 The on-going and continuous relocation of 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-clock trading in financial instruments and commodities; the rise of e-commerce and web business are few out of the many reasons why transfer pricing has become such a high profile over the last couple of decades.

3.8 Other considerations have also had an impact on the current importance of transfer pricing. Some developed countries 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 challenging transfer pricing regulations in their countries to keep their tax bases intact. Other developing countries are recognising that they need to address the challenges of transfer pricing in some way.

3.9 The USA transfer pricing regulations of 1994 and the risk of severe penalties, even in case of non-deliberate deviations from the arm’s length principle, have resulted in both the USA and foreign groups revising their transfer pricing methods. Countries with less sophisticated tax systems and administrations ran 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 since that time.

3.10 The OECD Committee on Fiscal Affairs continues to monitor developments in transfer pricing, in particular developments in the use of profit-based methods and in comparability matters. The EU Commission has also developed proposals on income allocation to members of

MNEs active in the European Union since 2001. Some of the approaches considered have included the possibility of a “common consolidated corporate tax base” and “home state taxation”¹. Under both options transfer pricing would be replaced by formulary apportionment, whereby taxing rights would be allocated between countries based upon the percentage of the worldwide business activity of an MNE conducted in those countries under an agreed formula, based upon some indicia of business activity such as some formulary combination of sales, payroll, and capital stock. In recent years a committee formed by the EU Commission, consisting of representatives of EU Member States and business experts (the EU Joint Transfer Pricing Forum), has developed proposals to improve transfer pricing dispute resolution (mutual agreement procedure, arbitration and advance pricing arrangements), and a proposal to harmonise transfer pricing documentation requirements. These proposals have been adopted as “codes of conduct” by the EU Council.

3.11 The OECD Transfer Pricing Guidelines have been widely accepted in principle including in the UN Model Double Tax Convention but some countries, especially developing countries, find it very difficult to implement such guidelines in practice. There are five different prescribed transfer pricing methods (described in more detail in subsequent chapters) to arrive at an arm's length price, but though all these methods may be able to provide a computation of the arm's length price (i.e., a “proper” transfer price) within the MNE, in practice they may end up with figures of profits between two MNEs being either more than 100% or less than 100% due to adjustments carried out by the tax authorities without “corresponding adjustments” by the other country on transactions within the MNE group.

3.12 The United Nations (UN) for its part published an important report on “International Income Taxation and Developing Countries” in 1988. The report discusses significant opportunities for transfer pricing manipulation by multinational enterprises (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 UN Conference on Trade and Development (UNCTAD) also issued a major report on Transfer Pricing in 1999.

3.13 The United Nations (UN) is again taking a leadership role, through this Transfer Pricing Manual, in trying to arrive at updated global transfer pricing guidelines which can be used by countries all over the world in developing (or calibrating) their transfer pricing regulations. Such guidelines which are arrived at through detailed debate and discussion amongst all the UN member nations, including both developed and developing countries, aims to truly reflect an overall global consensus with respect to transfer pricing.

¹ See, for more detail, http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm

4. Concepts in Transfer Pricing

4.1 The UN Model Convention Article 9(1) states the following

“Where

(a) an enterprise of a Contracting State participates directly or in-directly 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 have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of these conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly”

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, 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 Convention and the OECD’s 1995 and now 2010 Transfer Pricing Guidelines.

4.3 Thus, the “arm’s length principle” is currently the accepted guiding principle in choosing an acceptable “transfer price”. Note that 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.

4.4 Under the arm's length principle, transactions within a group are compared to transactions between unrelated entities to determine acceptable transfer prices. Thus, the marketplace comprising of 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

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-entity or intra-group transactions as equivalent to those between independent entities. Under the arm's length principle, the allocation of expenses and profits with respect to intra-group transactions is tested and 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

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 both source and residence jurisdictions 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 be provided with an incentive to avoid taxation through transfer pricing manipulation.

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 as it requires identifying and applying reliable comparable transactions.

4.8 Let us consider a practical example where the arm's length principle needs to be applied. Assume a corporation manufactures automobile seats in country A and sells the finished seats in country B (via its subsidiary, S) to unrelated parties (say, the public at large). In such a case S's taxable profits are determined by the resale price of its seats to the unrelated parties along with the price at which the seats were obtained from its parent corporation and its expenses other than cost of goods sold. Now if country A where the seats are manufactured has a tax rate much lower than country B's tax rate where the products are sold to the public at large i.e., unrelated parties, then maybe the corporation would have an incentive to book as much profit as possible in country A and to this end show a very high sale value of products to country B. If the tax rate was higher in country A than in country B then the corporation would show a very low sale value 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 financial relations may not be directly affected by market forces but will be influenced more by other considerations. The arm's length principle therefore seeks to determine whether the transactions between related taxpayers (in this case the corporation and its subsidiary S) reflect their true tax liability by comparing them to similar transactions between unrelated taxpayers at arm's length.

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.

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 dealing; any such adjustment may arise irrespective of the contractual terms between the entities. Another incorrect assumption, often made in practice, is that the commercial and financial relations between associated enterprises and the marketplace will without fail be different and always at odds with each other.

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

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 in terms of tax advantages (or disadvantages) that they create. It has been widely accepted and has found its way into most transfer pricing legislation across the world.

4.13 An alternative to the arm's length principle is the global formulary apportionment method which would allocate the global profits of a MNE group amongst the associated enterprises on the basis of a multi-factor weighted formula (the factors could be property, payroll and sales, for example). The formulary apportionment approach is being currently used by some states of the USA, cantons of Switzerland and provinces of Canada. As noted above, the EU is also considering a formulary approach, at the option of taxpayers, to harmonise its corporate taxes under the Common Consolidated Tax Base (CCTB) initiative.

(i) Applying the arm's length principle

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

(a) Comparability analysis

4.15 The concept of establishing comparability is central to the application of the arm's length principle. An analysis under the arm's length principle involves information on associated enterprises involved in the controlled transactions, the transactions at issue between the associated enterprises, the functions performed and the information derived from independent enterprises engaged in comparable transactions (i.e., uncontrolled transactions).

4.16 The objective of comparability analysis is always to seek the highest practicable degree of comparability, recognising that there will be unique transactions and cases where any applied method cannot be relied on. It is clear that the closest approximation of the arm's length price will be dependent on the availability and reliability of comparables.

4.17 There are many factors determining the comparability of transactions for transfer pricing analysis:

(1) Characteristics of the property or services

4.18 Property, tangible or intangible, as well as services, may have different 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 case of tangible property, the physical features, quality, reliability and availability of volume and supply;
- In the case of services, the nature and extent of such services; and
- In case of intangible property, the type and form of property, duration and degree of protection and anticipated benefits from use of property.

(2) Functional analysis (Functions, Assets and Risks)

4.19 In dealings between two independent enterprises, the compensation usually reflects the functions that each enterprise performs, taking into account assets used and risks assumed. Therefore, in determining whether controlled and uncontrolled transactions are comparable, a proper study of all specific characteristics of an international transaction or functional activity needs to be undertaken, including comparison of the functions performed, assets used and risks assumed by the parties. Such a comparison is based on a “functional analysis”.

4.20 A functional analysis seeks to identify and compare the economically significant activities and responsibilities undertaken by the independent and associated enterprises. An economically significant activity is considered to be any activity which materially affects the price charged in a transaction and the profits earned from that transaction.

4.21 Functional analysis is thus a key element in a transfer pricing exercise. It is a starting point and lays down the foundation of the arm’s length analysis. The purpose of functional analysis is to describe and analyse the operations of an enterprise and its associated enterprises.

4.22 Functional analysis typically involves identification of ‘functions performed’, ‘assets employed’ and ‘risks assumed’ (therefore named a "FAR analysis") with respect to the international transactions of an enterprise.

4.23 Functions that may need to be accounted for in determining the comparability of two transactions can include:

- Research and development
- Product design and engineering;
- Manufacturing, production and process engineering;
- Product fabrication, extraction and assembly;
- Marketing and distribution functions, including inventory management and advertising activities;
- Transportation and warehousing; and
- Managerial, legal, accounting and finance, credit and collection, training and personnel management services.
- Outsourcing nature of work
- Business process management

4.24 Risks that need to be considered while determining the degree of comparability between controlled and uncontrolled transactions include:

- Financial risks including method of funding, funding of losses, foreign exchange risk
- Product risk including design & development of product, after sales service, product liability risk, intellectual property risk, risks associated with R&D, obsolescence / upgrading of product
- Market risks including fluctuations in prices and demand, business cycle risks, development of market including advertisement and product promotion
- Credit and collection risks;
- Entrepreneurial risk including risk of loss associated with capital investment
- General business risks related to ownership of plant, property and equipment.

4.25 Furthermore it is not only necessary to identify the risks but to identify who *bears* such risks. The allocation of risk is usually based on contractual terms between the parties; however these may not always reflect the reality of a transaction or a relationship, and an allocation of risk between controlled taxpayers after the outcome of such risk is known or reasonably knowable lacks economic substance.

4.26 Consider an example where company S, situated in country A, is the wholly-owned subsidiary of company P, situated in country B but a foreign manufacturer. The subsidiary company S acts as the distributor of goods manufactured by the parent company P and both parties execute an agreement that any product liability costs will be borne by the parent company P. However, in practice when product liability claims are raised, subsidiary company S always pays the resulting damages. In such a case the tax authorities will generally disregard the contractual arrangement and treat the risk as having been in reality assumed by subsidiary company S.

(3) Contractual Terms

4.27 The conduct of the contracting parties is a result of the terms of the contract between them and the contractual relationship thus warrants careful analysis when arriving at the transfer price. Other than a written contract, the terms of the transactions may be figured out from correspondence and communication between the parties involved. In case the terms of the arrangement between the two parties are not explicitly defined, then the terms have to be deduced from their economic relationship and conduct.

4.28 One important point to note in this regard is that associated enterprises may not hold each other to the terms of the contract as they have common overarching interests, unlike 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 closer lacks reality, and is not valid under many legal systems) and/or have not been followed in reality.

4.29 Also, explicit contractual terms of a transaction involving members of a 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. This material may also indicate the *substance* of a transaction, but will usually not be determinative on that point.

4.30 It must be noted that contractual differences can influence *prices* as well as *margins* of transactions. The party concerned should document contractual differences and evaluate them in the context of the transfer pricing methods discussed in detail in a later chapter of this Manual, in order to judge whether comparability criteria are met and whether any adjustments need to be made to account for such differences.

(4) Market Conditions

4.32 Market prices for the transfer of the same or similar property may vary across different markets owing to cost differentials prevalent in the respective markets. Markets can be different for numerous reasons; it is not possible to itemise exhaustively all the market conditions which may influence transfer pricing analysis but some of the key market conditions which influence such an analysis are as follows:

4.33 **Geographical location** – In general, uncontrolled comparables ordinarily 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 market relevant to the transaction or (ii) adjustments can be made to account for the relevant differences between the two markets.

4.34 Another aspect of having different geographic markets is the concept of “*location savings*” which may come into play during transfer pricing analysis. Location savings are the cost savings that a MNE realises as a result of relocation of operations from a high cost jurisdiction to a low cost jurisdiction. Typically, cost savings include costs of labour, raw materials and tax advantages offered by the new location. However, there might be disadvantages in relocating also; the “*dis-savings*” on account of relocation might be high costs for transportation, quality control, etc. The savings attributable to location into a low cost jurisdiction (offset by any “*dis-savings*”) are referred to collectively as the “*location savings*”. The important point, where there are such location savings, is not just the amount of the savings, but also the issues of to whom these savings belong (i.e. the captive service provider or the principal). In this respect, the allocation of location savings depends especially on the relative bargaining positions of the parties. Relative bargaining power of buyer, seller and end user is dependent on issues such as the beneficial ownership of intangible property and the relative competitive position.

4.35 The computation of location savings might seem simple in theory; however its actual computation may pose many difficulties. Moving to an offshore location might be

accompanied by changes in technologies, productions volumes or production processes. In such a circumstance, the additional profit derived cannot be treated as only due to location savings as the profitability is due both to low costs and introduction of new technology. A simple comparison before and after in such a scenario would give a distorted picture of location savings.

4.36 If the tax authorities were to administer transfer pricing principles to “shift” profits without any consideration of market forces prevalent in the respective countries, then such reconfiguration of economic profile, and consequently the financial statements in the host country, would be against the principles of transfer pricing and may result in unrelieved double taxation if the tax authority in another country does not agree to reduce the profits of an associated enterprise in its country.

4.37 **Government rules and regulations** – Generally, government interventions in the form of price controls, interest rate controls, exchange controls, subsidies for certain sectors, anti-dumping duties etc, should be treated as conditions of the market in the particular country and in the ordinary course they 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 by controlled parties are consistent with “uncontrolled” transactions between independent enterprises.

4.38 An example of where government rules affect the market are the Export Oriented Units (EOU’s) which may be subject to beneficial provisions under the taxation laws of the country; ideally companies which enjoy similar privileges should be used as the comparables, and if that is not possible, adjustments may need to be made as part of the comparability analysis.

4.39 **Level of Market** – For example, the price at the wholesale level (sale to other sellers) and retail levels (sale to consumers) would generally differ, and there may be many levels of wholesalers before a product reaches the consumer.

4.40 **Other market conditions** – Some other market conditions which 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, size of the market, the extent of competition.

(5) Business Strategies

4.41 Business strategies relating to new product launches, innovations, market penetration or expansion of market share may require selling products cheaper as part of such a strategy and thus earning lower profit in the anticipation of increased profits in the coming years, once the product has become more established in the market. Such strategies must be taken into account when determining the comparability of controlled and uncontrolled transactions.

4.42 For example, “start-up” companies are prone to incurring losses during their early life and it would not generally be appropriate to include such start-ups when the tested party (i.e. the party in the controlled transaction to whom the transfer pricing method is applied) is a company with a track record over many years.

4.44 The evaluation of the claim that a business strategy was being followed which decreased profits in the short-term but provided for higher long-term profits is one that has to be considered by the tax authorities carefully after weighing several factors. One factor being - who bears the cost of the market penetration strategy? Another factor to consider is whether the nature of relationship reflects the taxpayer bearing the cost of the business strategy –for example, a sales agent with little responsibility or risk typically cannot be said to bear costs for a market penetration strategy. Another factor is whether the business strategy itself is prima-facie plausible or needs further investigation; an endless “market penetration strategy” that has yielded no profits in many years might under examination have no such real basis in practice.

(b) Transaction analysis

4.45 The arm’s length price must be established with regard to transactions *actually undertaken*; the 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 - such as that the real economic substance of the transaction differs from its form or the transaction arrangements are not structured in the commercially rational manner that would be expected between independent enterprises. In general, restructuring of transactions should not be undertaken lightly as it may lead to double taxation due to divergent views by the nation states on how the transactions are structured. Whether authorities are able to do so will ultimately depend on their ability to do so under applicable local law, and even where it is possible, a good understanding of business conditions and realities is necessary for a fair “reconstruction”. These issues are relevant not only to the administration of transfer pricing, but also to developing the underlying legislation at the beginning of a country’s transfer pricing “journey” to allow effective administration (and to assist, and reduce the costs of, compliance by taxpayers) during the course of that journey.

(c) Evaluation of separate and combined transactions

4.46 An important aspect of transfer pricing analysis is whether this analysis is required to be carried out with respect to individual international transactions or a group of international transactions having close economic nexus.

4.47 In most cases, it has been observed that application of the arm’s length principle on a transaction-by-transaction basis becomes cumbersome for all involved, and thus recourse is often had to the “aggregation” principle.

4.48 For example with transactions dealing with intangible property such as the licensing of “know-how” (practical technical knowledge of how to do something, such as of an industrial process, that is not widely-held) to associate enterprises it may prove difficult to separate out the transactions involved. Similarly long-term service supply contracts and pricing of closely linked products are difficult to separate out transaction-wise.

4.49 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 royalties, leases, sale and licenses all

packaged into one deal. The tax authorities would generally consider the deal in its totality and arrive at the appropriate transfer price; in such a case comparables need to be similar (deals between independent enterprises). In certain cases, the tax authorities might find it appropriate for various reasons to allocate the price to the elements of the package or composite contract.

4.50 It must be noted that any application of the arm's length principle, whether on a transaction by transaction basis or on aggregation basis, needs to be evaluated on a case to case basis, applying the relevant methodologies to the facts as they exist in that particular case.

(d) Use of an arm's length range

4.51 The arm's length principle as applied in practice usually results in an arm's length *range* (that is, a range of acceptable/comparable prices) rather than a single transfer price for a controlled transaction. The range of transfer prices exists because the transfer pricing methods attempt to reflect prices and conditions between independent parties. However at times it is difficult to make highly precise adjustments due to differences between controlled transactions and uncontrolled transactions. If only one transfer pricing method is applied, the method may indicate a single acceptable price range. If more than one transfer pricing method is being used, each method may indicate different ranges. If the range of prices that are common to the methods is used, the range is more likely to be reliable in fairly reflecting business conditions.

4.52 If the transfer prices used by a taxpayer are within the arm's length range, adjustments should not be required. If the transfer prices used by a taxpayer are outside the range of prices determined by a tax authority, the taxpayer should be given an opportunity to explain the differences.

4.53 If a taxpayer is able to explain the difference and provides its own transfer pricing documentation used in setting its transfer prices which supports this, a tax authority will usually decide not to make adjustment. On the other hand, if the taxpayer is unable to justify its transfer prices an adjustment may be required.

(e) Use of multiple year data

4.54 When economic and financial data is being tested, previous years' data may truly represent the results achieved by both the controlled and uncontrolled taxpayers. The use of multiple year data allows the data to be better harmonised, as it tends to average the results over a period of time. Multiple year data can also uncover relevant abnormal economic factors affecting the results, such as strikes or other adverse conditions. Such an approach also tries to test the data thrown up in typical business cycles and thus eliminates the risk of testing data of only a particularly bad or good year.

4.55 Furthermore, in certain industries which are more cyclical in nature the multiple year data may give a better standard of comparison than use of single year data; the automotive industry can be one example of such a cyclical industry. That is not to say, however, that use of multiple year data prevents authorities from challenging artificial attempts to take advantage of

such an approach by, for example, wrongly pricing in the last year of the data in the hope that such pricing will be “absorbed” into the wider data set. Some countries consider that they are legally required to consider data on a year-by-year basis; that will be a matter for domestic law, but if the choice exists when setting up a transfer pricing regime, it would generally be preferable to have a multi-year approach to deal with legitimate variations in business conditions across years.

4.56 While using multi-year data for comparability analysis, it is in any case necessary to adjust for factors such as the occurrence of significant events in the preceding years and the role of inflation in changing prices of commodities and services.

4.57 Overall, multiple year data provides information about the relevant business and product life cycles of the comparables; differences in business or product life cycles may have an effect on the conditions which determine comparability. Data from previous years can show whether an independent enterprise engaged in comparable transactions was affected by similar economic conditions so as to be used as a comparable or not.

(f) Losses

4.58 In an MNE group, one of the enterprises might be suffering a loss, even a recurring one, but the overall group may be extremely profitable. The fact that there is an enterprise making losses that is doing business with profitable members of its MNE group may warrant scrutiny by the tax authorities concerned. Such a situation perhaps indicates that the loss-making enterprise is not receiving adequate compensation from the MNE group of which it is a part in relation to the benefits derived from its activities.

4.59 However there are many facets of these losses that have to be studied such as the *nature of the loss* (spread across group, history of loss-making within entity and group etc), the *reasons for the loss* (economic downtime, business cycle, start-up business, poor management, excessive risk etc), and the *period of loss* (short-term, long-term) as all these factors play a significant role in determining how the loss should be treated with respect to transfer pricing.

(g) Intentional set-offs

4.60 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 that each has received should be set-off against the benefit each provided and only the net gain or loss if any on the transactions needs to be considered for tax assessment.

4.61 Set-offs can be quite complex; they might involve a series of transactions and not just a simple “one transaction, two party” 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 set-offs, the conditions governing the transactions are consistent with the arm’s length principle.

4.62 The tax authorities may evaluate the transactions separately to determine which of 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, such as due to the differences in the tax treatment of the set-offs under the taxation systems of different countries.

(h) Use of custom valuations

4.63 The General Agreement on Trades and Tariff (GATT, Article VII), now part of the World Trade Organization (WTO) set of agreements, has laid down the general principles for an international system of custom valuation. Customs valuation is the procedure applied to determine the customs value of imported goods. Member countries of WTO typically harmonise their internal legislation dealing with the customs valuation with the WTO Agreement on Customs Valuation.²

4.64 In appropriate circumstances, the documented custom valuation may be used for justifying the transfer prices of imported goods in international transactions between associated enterprises. The arm's length principle is applied by many customs administrations as a principle of comparison between the value attributable to goods imported by associated enterprises and the value of similar goods imported by independent enterprises. However when there is no customs duty imposed and goods are valued only for statistical purposes, and for items which have no rate of duty, this approach would not be useful. Even when utilising the custom 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 taxation.

4.65 Internationally, there is a great deal of focus on the interplay of transfer pricing methods on the one hand and custom valuation methods on the other hand. Debates have centred on the feasibility and desirability of the convergence of the systems surrounding the two sets of value determination. The issue is considered in more detail in a later chapter.

(i) Use of transfer pricing methods

4.66 The transfer pricing methods are set forth in more detail in the following section, and are dealt with more fully in a later chapter. It is, however, important to note at the outset that there is no one transfer pricing method which is generally applicable to every possible situation.

4.67 The bottom line is that comparables play a critical role in arriving at arm's length prices; it is also abundantly clear that computing an arm's length price using transfer pricing analysis is a complex task; it requires a lot of effort and good will from both the taxpayer and the tax authorities in terms of documentation, groundwork, analysis and research. This Manual seeks to assist developing countries in that task as much as is possible, but it has to be recognised that it will nevertheless hardly ever be a simple one.

² See http://www.wto.org/english/tratop_e/cusval_e/cusval_e.htm

5. Transfer Pricing Methods

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.

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.

5.3 The five major transfer pricing methods (all discussed in more detail later in this Manual) are:

(i) Comparable Uncontrolled Price (CUP)

5.4 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.

(ii) Resale Price Method (RPM)

5.5 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 reseller is sufficient to allow it to cover its selling and operating expenses and make an appropriate profit.

(iii) Cost Plus (C+, CP)

5.7 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 the supplier incurred an appropriate gross margin so that the supplier will make an appropriate profit in the light of market conditions and functions he or she performed.

(iv) Profit-based methods

5.10 Two classes of transactional profit methods are recognised by the USA Section 482 IRS regulations and the OECD Guidelines— they are (the class of) *profit-comparison methods* (Transactional Net Margin Method or TNMM / Comparable Profits Method or CPM) and (the class of) *profit-split methods* (PSM).

(a) Profit comparison methods (TNMM/CPM)

5.11 These methods seek to compare the level of profits that would have resulted from controlled transactions with the return realised by the comparable independent enterprise. The TNMM compares the net profit margin realised from the controlled transactions with the net profit margin realised from uncontrolled transactions.

(b) Profit-split methods (“PSM”)

5.13 Profit-split methods take the combined profits earned by two related parties from one or a series of transactions and then divide the profits using a defined basis that is aimed 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 from both parties by working back from profit to price.

5.16 The first three methods above i.e. CUP, RPM and Cost-Plus are often called “traditional transaction” methods and the last two are called “profit-based” methods although 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 USA regulations provide for the use of additional methods applicable to global dealing operations like the Comparable Uncontrolled Transactions (CUT) method. This method is similar to 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.

5.17 Though the OECD in the past preferred using transactional methods over profit methods, the ‘best-method-rule’ (originally found in the USA Transfer Pricing regulations) which allows any of the methods which best represent the transfer price to be chosen and the taxpayer is not required to disprove the use of other methods has now been commonly accepted and adopted in transfer pricing guidelines and regulations worldwide in one form or the other.

6. Special Issues Related to Transfer Pricing

(i) Documentation requirements

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.

6.2 At every stage of the transfer pricing process, varying degrees of documentation are necessary. 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 whether or not the tax payer 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 enterprises

6.3 Broadly, the information or documents that the taxpayer needs to provide can be classified as

(i) *enterprise-related documents* (for example the ownership / shareholding pattern of the taxpayer, the business profile of the MNE, industry profile etc);

(ii) *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 transactions etc), and

(iii) *computation-related documents* (for example the nature of each international transaction and the rationale for selecting the method for each international transaction, actual computation of the arm's length price, factors and assumptions influencing the determination of the arm's length price etc.)

6.4 Furthermore, the domestic legislation of some countries requires "contemporaneous documentation". The Oxford Dictionary defines the term "contemporaneous" as "*existing or occurring in the same period of time*", so that such documentation cannot be created after the transaction is effected. Contemporaneous documentation maintained in accordance with such obligations should have the characteristics of completeness, accuracy and timeliness.

(ii) Intangibles

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

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 uniqueness 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.

6.7 In cases where both parties own valuable intangibles, typically the profit-split method is used. In cases involving sub-licensing of intangibles by associated enterprises to third parties, Cost Plus Method can be used. In case of a *sale* of an intangible, CUP may be used if there exists an internal comparable.

(iii) Intra-group services

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. Furthermore, any incidental benefit solely by being the member of an MNE group, without any specific services provided or performed, should be ignored.

6.9 An arm’s length price for intra-group services may be determined directly or indirectly – in the case of direct charge, the CUP method could be used if comparable services are provided in the open market. In the absence of CUP, the cost-plus method could be appropriate to apply in such cases.

6.10 If a direct charge method is difficult to apply, the MNE may apply the charge indirectly via cost sharing or incorporating a service charge or not charging at all. Such methods would usually be accepted by the tax authorities only if the charges are supported by foreseeable benefits and if the methods are based on sound accounting and commercial principles and are capable of producing charges or allocations that are commensurate with the reasonably expected benefits to the recipient.

(iv) Cost-contribution agreements

6.11 Cost-contribution agreements (CCAs) may be formulated among group companies 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 benefits from the developed property without further payment. Such arrangements tend to involve research and development or services such as centralised management, advertising campaigns etc.

6.12 In a CCA there is not always a benefit that ultimately arises; only an expected one during the course of the CCA. The interest of each participant should be agreed upon at the outset. The contributions are required to be consistent with what 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.

(v) Use of “secret comparables”

6.13 There is often concern expressed by enterprises over aspects of data collection by tax authorities and its confidentiality. The fact is that tax authorities are privy to, as they need to be, very sensitive and highly confidential information about taxpayers, such as relating to margins, profitability and 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.

6.14 A secret comparable generally means the use of information or data about a taxpayer by the tax authorities to form the basis of transfer pricing scrutiny of another taxpayer, who is often not given access to that information – it may reveal confidential information about a competitor’s operations, for example.

6.15 Caution may be exercised in prescribing the use of secret comparables unless the tax authorities are able to (within limits of confidentiality) disclose the data to the taxpayer so as to defend against an adjustment. The reason for this caution is that taxpayers may contend that use of such secret information is against the basic principles of equity, as the taxpayer is required to benchmark his controlled transactions with comparables not available to him, without the opportunity to question comparability or argue that adjustments are needed.

7. Transfer Pricing in Treaties

(i) United Nations and OECD Model Conventions: An Overview

7.1 The OECD Model Convention was first published in 1963 and then later in 1977, following up some work done by the League of Nations, and then after World War II, by the United Nations. A read-only, but downloadable, version of the OECD Model is available at <http://www.oecd.org/dataoecd/14/32/41147804.pdf>. The United Nations produced a UN Model Convention for treaties between developed and developing nations in 1980, with a new version produced in 2001. It is currently being further revised. 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. The UN Model is available at <http://www.un.org/esa/ffd/tax/>.

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

(ii) Transfer pricing and the Model Conventions

7.3 The OECD Model Article 9 is a statement of the arm's length principle and allows for profit adjustments if the actual price on transactions between associated enterprises differs from the price 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, 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 Authorities of the Contracting States are if necessary to consult with each other in determining the adjustment.

7.4 Other OECD Model Convention Articles which apply the arm's length principle include the dealings between the head office and the permanent establishment (Article 7(2)). Article 7(4) previously explicitly permitted the use of the profit-split method 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. The OECD Model treaty also explicitly excludes the amount of interest and royalties in excess of arm's length amount from treaty benefits under Article 11(6) and 12(4).

7.5 The UN Model (2001) contains similar provisions to the OECD Model in Article 9 and therefore serves as guide for applying the arm's length principle for developing countries; however the UN Model also includes an additional paragraph which stipulates that a Contracting state is not required to make the corresponding adjustment referred to in the second paragraph 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 penalty with respect to fraud, gross or wilful default.

7.6 There is some ambiguity in the concept of "associated enterprises" in the context of the Model Conventions – the term is used in the heading of Article 9, but not in the text, for example. The Model Conventions use the concept to cover relationships between enterprises which are sufficiently close to attract transfer pricing application. While "management" and "capital" appear fairly straightforward, "control" is a concept whose definition is often extended under the domestic law in many countries. For example, if parties to the transaction make arrangements differing from those made by unrelated parties it 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.

7.7 Furthermore, the Model Conventions spell out a key transfer pricing dispute resolution mechanism – the Mutual Agreement Procedure – in Article 25. The MAP facilitates the settlement of disputes on corresponding adjustments among "Competent Authorities" (officials designated by countries to discuss treaty and other international tax-related issues with each other). Note that the Mutual Agreement Procedure does not guarantee relief as it is voluntary

but there is a duty to negotiate in good faith to try to achieve a result consistent with the treaty allocation of taxing rights.

7.8 Finally, there are a small number of bilateral treaties which allow for arbitration to resolve transfer pricing disputes. Also of note in this regard is the EU Arbitration Convention (Convention 90/436/EEC 1990) which establishes a procedure to resolve disputes where double taxation occurs between enterprises of different Member States as a result of an upward adjustment of profits of an enterprise of one Member State. This concept of arbitrated solutions where MAP does not lead to a result is also under discussion in relation to the UN Model, with special consideration of possible issues for developing countries.

7.9 Overall, the Model Conventions are a critical source of acceptability for the arm's length principle. Given that many countries around the world follow fairly closely one or other of the Model Conventions, the arm's length principle has been widely accepted, even though its imperfections are also widely recognised.

(iii) Relevance of UN and OECD Models and OECD guidelines for developing countries

7.10 Transfer pricing rules have been developed mainly within the member countries, i.e., developed countries, of the OECD only because of their historical and economic backgrounds. Now, many developing countries face some of the same conditions as the OECD countries did in the 1970's through 1990's and which are discussed in the OECD Guidelines. Thus, when it comes to the evolution of the UN Models and Guidelines, attention should be focused on the following areas in which many developing countries are encountering difficulties with administering the arm's length principle.

7.11 Developing countries often have substantial problems with the availability of comparable transactions. This issue is considered more fully in a subsequent section and 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. When a flexible approach cannot produce any comparables, a profit-split approach can be used as the last resort. Basically, a profit-split requires intensive information from both sides for the transactions concerned. However, if the transaction is simple, e.g. a fee-based business, and the risk of tax base erosion by that pricing is not considered large, a simplified approach for profit splits can be negotiated between taxpayers and tax authorities, where the domestic law allows. In order for such an approach to be broadly acceptable, including to investors, it should reflect some economically reasonable criteria expected for the local operation of that business.

7.12 Documentation requirements should as far as possible be common between two Models (UN and OECD), because diversity in documentation rules obliges excessive compliance cost on the MNEs, as well as smaller enterprises. Targeted documentation requirements can be

an alternative to the full-scale documentation, in case transactions are simple and the tax due is not large. This may be especially important in responding to the needs and capabilities of small and medium enterprises (SMEs).

8. Transfer Pricing in Domestic Law

(i) Introduction

8.1 Article 9 of tax treaties typically only regulates the basic conditions for adjustment of transfer pricing and advises the application of 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.

8.2 It must be stressed thus that Transfer pricing regimes are creatures of domestic law and each country for implementing transfer pricing rules are required to formulate detailed domestic legislation. Many countries have passed such domestic transfer pricing rules for international transactions which typically tend to limit their transfer pricing rules to cross-border related transactions only

8.3 It is important to note that the definition of "associated enterprise" is based on domestic needs 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 or more than 50%) 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 for what are in reality larger transactions to be split into apparently smaller transactions to avoid the operation of the law.

8.4 It must be noted that while transfer pricing being essentially domestic regulation has a long history proving that international consistency of TP rules is beneficial not only regarding the basic structure of taxable person and events but also in the manner of application of the arm's length principle. This consistency is an important goal to be aimed at in terms of encouraging investment in a country and international trade that assists a country's development, although 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.

(ii) Safe harbours

8.5 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 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 the cases where more is likely to be at stake in terms of non compliance and revenue. One example of a "safe harbour" is a rule that a taxpayer is deemed to have an appropriate transfer price when the average export sales price is at least 90% of the average domestic sales in the domestic market during the same period and under similar payment terms. Another example is a list of parameters that, if followed, will assure sale and leaseback treatment to certain transactions under which partial or total relief from transfer pricing obligations is granted.

8.6 Safe harbour rules are, therefore, rules whereby if a taxpayer's reported profits are within a range or percentage or under a certain amount, or the like, that amount can be relied on by a taxpayer as an alternative to a more complex and burdensome rule, such as applying the transfer price methodologies. A safe harbour cannot normally be used to the disadvantage of a taxpayer. There are some risks to safe harbours, such as that may favour low profit margin transactions that do not develop the economy in the long term, they may over time no longer reflect business realities, and may unreasonably either favour or dis-favour certain taxpayers. Where they are unfavourable to taxpayers, the usual option of not following them, but instead following the "normal" rules, would generally be taken by taxpayers, but where they do provide unusually *favourable* treatment, including if business conditions have changed over time to make them unexpectedly favourable, it may become very difficult to change or remove such rules. In any case, consistent with the purpose of this Manual, introducing a safe harbour rule should involve analysis of whether, in a broad sense, even though not involving a precise analysis of every case; they essentially represent the real-world application of the arm's length principle.

(iii) Controlled Foreign Corporation provisions

8.7 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 held a controlling shareholding in low tax jurisdictions and "parking" income there. CFC rules treat this income as though it has been repatriated and is therefore taxable prior to 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 conditions, it is widely considered that transfer pricing should have priority in application over CFC rules. After the application of transfer pricing rules, countries can apply the CFC rules on the retained profit of foreign subsidiaries, however.

(iv) Thin Capitalisation

8.8 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 view point to finance a company by way of loans (i.e., leveraging) rather than by way of equity contributions as typically the distribution of interest on the debts may be deducted as interest whereas distribution on stock 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.

(v) Documentation

8.9 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 arm's length principle being met for the specified taxpayers. However, there is some divergence of legislation in terms of the nature of documents required, penalties imposed, and the degree of 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.

8.10 In deciding requirements for such documentation, there needs to be, as already noted, a recognition of the compliance costs imposed on those required to produce the requirements, the issue of whether the benefit, if any, of such requirements from the administration's view in dealing with (for example) a 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 widely accepted international approach, which takes into account compliance costs for taxpayers, should be followed unless a deviation 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. The chapter on documentation in this Manual will seek to distil some of these widely accepted approaches.

(v) Advance Pricing Agreements

8.11 Recently, multi-national businesses have often depended on Advance Pricing Agreements (APAs) (or "Advance Pricing Arrangements", as some countries prefer) with authorities, especially with the Mutual Agreement Procedure agreement. 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 bilateral or multilateral. Many countries have introduced APA procedures in their domestic laws though having different legal forms. For example, in certain countries, it may be a legally binding engagement between taxpayers and tax authorities, and in other countries, it may be a one-way concessional document by tax authorities. The pros and cons of APAs for developing country administrations and taxpayers, and some implementation issues, are addressed in a later chapter.

(vi) Time limitations

8.12 Another important issue for transfer pricing domestic legislation is the "statute of limitation." issue – the time allowed in domestic law for the administration to do the transfer pricing audit and make necessary assessments or the like. Since a transfer pricing audit can place heavy burdens on both taxpayers and tax authorities, the normal "statute of limitation"

for taking action is often extended to some extent compared with general domestic taxation cases. However, too long a period during which adjustment is possible leaves taxpayers in certain positions with possible large financial risks. 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.

(vii) Domestic transfer pricing rules and Tax Treaties

8.13 Developed and developing countries have domestic transfer pricing rules to counter tax transfer pricing manipulation and the associated enterprises article of tax treaties (usually Article 9) deals with 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, which is generally accepted, is that tax treaties do not increase a country's 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.

8.14 One view is that a country's tax jurisdiction, usually some mixture of residence and source-based jurisdiction, 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 coordinate 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 both the requirements of the treaty country's domestic law and the tax treaty are 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, the documentation required and so forth. As a consequence of these factors, it is generally considered that countries 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.

8.15 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 have transfer pricing measures or do not enforce their transfer pricing measures, there is an incentive 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.

8.16 That international enterprises might use transfer prices to shift profits from lower tax countries to higher tax countries is a paradox. It is normally expected that an international enterprise would shift profits from higher tax countries to lower tax countries, but international

enterprises 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 minimise the risk of transfer pricing adjustments and penalties in that jurisdiction. Moreover, transfer pricing disputes are generally time consuming and expensive.

9. Global Transfer Pricing Regimes

9.1 The UN and OECD Model Conventions, the OECD Guidelines and domestic legislation such as that of the USA have provided examples for the creation of transfer pricing legislation by nation states worldwide, as a response to increasing globalisation of business and the concern that it may be abused to the detriment of countries without such legislation. Many other countries rely on general anti-avoidance rules to deal with the most abusive forms of transfer pricing, an issue considered under the chapter on the legal environment for transfer pricing.

9.2 By the end of 2009, there were around 53 countries with some form of specific transfer pricing legislation as shown by the light blue shading in the diagram below.



10. Transfer Pricing as a Current and Future Issue for Developing Countries

(i) General issues with transfer pricing

10.1 Several issues arise when applying the arm's length principle used in the existing OECD Transfer Pricing Guidelines 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. Some even contend that the arm's length principle can only strictly be applicable in situations where direct comparable uncontrolled transactions exist.

10.2 Increasing globalisation, sophisticated communication systems and information technology allow an international enterprise to control the operations of its various subsidiaries from one or two locations worldwide. Trade between associated enterprises is often in intangible items, such as services and software. Developed countries have undergone structural changes and are witnessing tremendous growth in their service sectors while having a declining demand for products. 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 globalised 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.

10.3 Furthermore, 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 judgment 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, often requiring their best officers, who may, after skilling-up leave the organisation in view of their special skills. The intention of this Manual is to play one part in reducing those gaps.

(ii) Transfer pricing and developing countries

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 speaking.

10.5 Some of the specific challenges 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:

(a) Lack of comparables

10.6 One of the foundations of the arm's length principle is comparative pricing. Proper comparability is often found difficult 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, Resale price, Cost plus) directly rely on comparables. These comparables have to be close in order to be of use for the transfer pricing analysis. It is often in practice extremely difficult, especially in some developing countries, to obtain adequate information to apply the arm's length principle for the following reasons:

(a) In developing countries there tends to be fewer organised players in any given sector than in developed countries; finding proper comparable data can be very difficult;

(b) In developing countries, the comparable information may be incomplete and in a form which is difficult to analyse because 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

(c) In many developing countries the economies of which have just opened up or are in the process of opening up, there are many "first movers" 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.

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 in developing countries finding appropriate comparables for analysis is quite possibly the biggest practical problem faced currently by enterprises and tax authorities alike, but the aim of this Manual is to assist that process in a practical way.

(b) Lack of knowledge and requisite skill-sets

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 specialised area is not readily available.

(c) Complexity

10.9 Rules based on the arm's length principle are becoming increasingly difficult and complex to administer. Transfer pricing compliance today typically involves huge and expensive databases and high-level expertise to handle. Transfer pricing audits need to be performed on a case-by-case basis and are often complex and costly tasks for all parties concerned.

10.10 In developing countries, resources, monetary and otherwise, may be limited for the

taxpayer (especially a SME) who has to prepare detailed and complex transfer pricing reports and comply with the transfer pricing regulations, and 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. Furthermore, the transfer pricing audits tend to be long drawn, time consuming may be contentious and may ultimately result in “estimates” fraught with conflicting interpretations.

10.11 In case of disputes *between* the revenue authorities of two countries, the current available prescribed option is Mutual Agreement Procedure (MAP). This too can possibly lead to a protracted and involved dialogue, often between unequal economic powers, and may cause strain on the resources of the companies in questions and the revenue authorities of the developing countries.

(d) Growth of the “intangible economy”

10.12 The fact is that the Internet is a disruptive medium; it 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.

10.13 The issue of effectively dealing with intangibles is especially critical for some developing countries where the prime driver for growth has been the Information Technology industry which has seen a huge growth curve over the last decade creating millions of jobs. The different kind of challenges thrown up by fast-changing web-based business models cause special difficulties.

10.14 From the viewpoint of many developing countries, it is essential for them to be able to tax the profits on certain intangible-related transactions, such as e-commerce and web-based business models, because of the perceived economic connection of the transaction with that country.

(e) “Location savings”

10.15 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.

10.16 Accordingly the determination of location savings, and its 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 recognise geographic conditions and ownership of intangibles. The USA Section 482 regulations provide some sort of limited guidance in the form of recognising 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 issue is dealt with in greater detail later in this Manual.

11. Summary and Conclusions

11.1 Transfer pricing is generally considered the major international taxation issue faced by MNEs today. It is an enormously important issue for many countries, developing and developed. 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.

11.2 For both governments and taxpayers, transfer pricing is difficult to grapple with; 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 for applying the transfer pricing methods.

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. Furthermore, from the government's perspective, transfer pricing manipulation reduces revenue available for country development, and with increasing globalisation, the potential loss of revenue may run into billions of dollars.

11.4 Overall, to simplify the international taxation system, especially transfer pricing, while keeping it equitable and judicious for all parties involved, is a difficult task. But a practical approach, such as proposed by this Manual, will help ensure the focus is on solutions to these problems and will help equip developing countries to address transfer pricing issues in a way that is robust and fair to all the stakeholders, while remaining internationally coherent and seeking to reduce compliance costs and the incidence of unrelieved double taxation.

11.5 This chapter served 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.