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Committee of Experts on International Cooperation in Tax Matters
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Agenda item 3 (b) (i)
Update of the United Nations Practical Manual on Transfer Pricing for Developing Countries

Coordinator's Report on Work of the Subcommittee on Transfer Pricing

Background

The Committee of Experts on International Cooperation in Tax Matters ("the Committee") began its work on the United Nations Practical Manual on Transfer Pricing for Developing Countries ("the Manual") in 2009, when it established its first Subcommittee on Transfer Pricing. The Manual was adopted by the Committee during its 2012 annual session and was issued in print form in 2013. As the former membership of the Committee was dissolved at the end of June 2014, so too were the Subcommittees formed by that Membership.

The Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing ("the Subcommittee") was created at the first session of the current membership of the Committee in 2013 (the 9th session of the Committee) with the goal to take the Committee's work in this area forward, including updating the Manual in a fast-changing international transfer pricing environment.

The Mandate

The Subcommittee was mandated by the Committee to carry out work within two different areas of transfer pricing: (i) Revision of the Commentary on Article 9 of the UN Model Convention;

and (ii) Update and enhancement of the United Nations Practical Manual on Transfer Pricing for Developing Countries. The Mandate was as follows:

> The Subcommittee as a Whole is mandated to update the United Nations Practical Manual on Transfer Pricing for Developing Countries, based on the following principles:
>
> - That it reflects the operation of Article 9 of the United Nations Model Convention, and the Arm's Length Principle embodied in it, and is consistent with relevant Commentaries of the U.N. Model;
> - That it reflects the realities for developing countries, at their relevant stages of capacity development;
> - That special attention should be paid to the experience of developing countries; and
> - That it draws upon the work being done in other fora.

In carrying out its mandate, the Subcommittee shall in particular consider comments and proposals for amendments to the Manual and provide draft additional chapters on intra-group services and management fees and intangibles, as well as a draft annex on available technical assistance and capacity building resources such as may assist developing countries. The Subcommittee shall give due consideration to the outcome of the OECD/G20 Action Plan on Base Erosion and Profit Shifting as concerns transfer pricing and the Manual shall reflect the special situation of less developed economies.

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

Subcommittee Membership

The Subcommittee is comprised of Members from tax administrations with wide and varied experience in dealing with transfer pricing as well as Members from academia, international organizations and the private sector, including from multinational enterprises and advisers.

The members of the Subcommittee and their countries (in the case of government officials) or affiliations (in other cases) at the time of writing are, although membership is assumed on a personal capacity:

Members of the UN Tax Committee who are also Subcommittee Members

- Mr. Stig Sollund, Coordinator (Norway)
- Ms. Noor Azian Abdul Hamid (Malaysia)
- Mr. Johan Cornelius de la Rey (South Africa)
- Mr. Toshiyuki Kemmochi (Japan)
- Mr. Henry Louie (USA)

- Mr. Enrico Martino (Italy)
- Ms. Pragya Saksena (India)
- Mr. Christoph Schelling (Switzerland)
- Ms. Xiaoyue Wang (China)
- Ms. Ingela Willfors

Other Subcommittee Members

- Mr. Marcos Valadao (Brazil)
- Mr. Ganapati Bhat (India)
- Ms. Caroline Silberztein (Baker & McKenzie, France)
- Mr. Giammarco Cottani (Ludovici & Partners, Italy)
- Mr. Joe Andrus
- Ms. Jolanda Schenk (Shell, Netherlands)
- Mr. Michael Kobetsky (University of Melbourne, Australia)
- Mr. Michael McDonald (USA)
- Ms. Monique van Herksen
- Ms. Nishana Gosai (Baker & McKenzie, South Africa)
- Mr. TP Ostwal (TP Ostwal & Associates, India)
- Mr. Toshio Miyatake (Adachi, Hendersen, Miyatake & Fujita)
- Mr. George Obell (Kenya)
- Mr. Julius Bamidele (Nigeria)
- Mr. Carlos Perez-Gomez Serrano (Mexico)
- Ms. Melinda Brown (OECD)
- Mr. Ruslan Radzhabov (Russian Federation)
- Ms. Ying Zhang (China)
- Mr. Hafiz Choudhury (The M Group)

The assistance to the Subcommittee is also acknowledged for Mr. Cao Houle (China) as well as Mr. Marc Bochsler and Mr. Basil Speyer (both of Switzerland).

The Subcommittee Work

During the 11th Annual Session, the Committee acknowledged that the first part of the Subcommittee's mandate, to update the commentary on article 9, had been completed, and the updated commentary adopted, for inclusion in the next update of the Model Convention. As a result, the Subcommittee has since continued working on the second part of its mandate, by proposing an updated and reordered version of the United Nations Practical Manual on Transfer

Pricing for Developing Countries for adoption by the Committee. The proposed text is as provided in the Attachments to this note.

Since the 11th Annual Session, the Subcommittee met three times, (i) in November 2015, in Santiago, Chile; (ii) April 2016 in Bergamo, Italy and finally (iii) in September 2016, in New York

The Manual is in the Subcommittee's view improved by the proposed re-ordering and the additions, and made more responsive to issues of current country concern and also more in tune with rapid developments in this area. It was decided by the Subcommittee, that the Manual was not the best place for a draft annex on available technical assistance and capacity building resources such as may assist developing countries, as mentioned in the mandate. This was considered better addressed by a webpage updated and managed by the UN Secretariat.

The changes in this edition of the Model include:

- A revised format and a rearrangement of some parts of the Manual for clarity and ease of understanding, including a reorganization into four parts as follows:
    - Part A includes substantive issues as they relate to transfer pricing;
    - Part B contains guidance on design principles and policy considerations;
    - Part C addresses practical implementation of a transfer pricing regime in developing countries; and
    - Part D contains country practices, similarly to Chapter 10 of the previous edition of the Manual. A new statement of Mexican country practices is included and other statements are updated;
- A new chapter on intra-group services;
- A new chapter on cost contribution arrangements;
- A new chapter on the treatment of intangibles;
- Significant updating of other chapters, taking account other global issues such as the relevant parts of the outputs of the G20/OECD action plan on BEPS; and
- An index to make the contents more easily accessible (to be constructed later)

Subcommittee Proposal

During the 12th Session of the Committee of Experts, the Subcommittee on Transfer Pricing wishes to bring the new proposed version of the Manual to this Committee's attention for its approval, with a view to its being published and publicized in Spring 2017, after necessary editing and checking to be led by Mr. Sollund.

The Annexes

The papers attached have been prepared by the Subcommittee and will instruct the new proposed version of the Manual on Transfer Pricing. The Subcommittee would like to present the following papers for consideration and approval by the Committee of Experts during the 12th Session:

- Introduction to Transfer Pricing (Annex 1)
- Country Chapter – Brazil (Annex 2)
- Country Chapter – India (Annex 3)
- Country Chapter – Mexico (Annex 4)
- Country Chapter – South Africa (Annex 5)

**Further chapters will be made available during the course of the meeting.

Annex 1

B.1. INTRODUCTION TO TRANSFER PRICING

B.1.1. What Is Transfer Pricing?

B.1.1.1. This introductory chapter gives a brief outline of the subject of transfer pricing and addresses the practical issues and concerns surrounding it, especially the issues faced and approaches taken by developing countries. These are then dealt with in greater detail in later chapters.

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

B.1.1.3. A significant volume of global trade nowadays consists of international transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within an MNE group; such transfers are called "intra-group transactions". There is evidence that intra-group trade is growing steadily and arguably accounts for more than 30 percent of all international transactions.

B.1.1.4. In addition, transactions involving intangibles and multi-tiered services constitute a rapidly growing proportion of an MNE's commercial transactions and have greatly increased the complexities involved in analysing and understanding such transactions.

B.1.1.5. The structure of transactions within an MNE group[1] is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. A large and growing number of international transactions are therefore no longer governed entirely by market forces, but driven by the common interests of the entities of a group.

B.1.1.6. In such a situation, it becomes important to establish the appropriate price, called the "transfer price", for intra-group, cross-border transfers of goods, intangibles and services. "Transfer pricing" is the general term for the pricing of cross-border, intra-firm transactions between related parties. Transfer pricing therefore refers to the setting of prices[2] for transactions between associated enterprises involving the transfer of property or services. These transactions are also referred to as "controlled" transactions, as distinct from "uncontrolled" transactions

[1] The component parts of an MNE group, such as companies, are called "associated enterprises" in the language of transfer pricing.

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

between companies that are not associated and can be assumed to operate independently ("on an arm's length basis") in setting terms for such transactions.

B.1.1.7. Transfer pricing thus does not necessarily involve tax avoidance, as the need to set such prices is a normal aspect of how MNEs must operate. Where the pricing does not accord with internationally applicable norms or with the arm's length principle under domestic law, the tax administration may consider this to be "mis-pricing", "incorrect pricing", "unjustified pricing" or non-arm's length pricing, and issues of tax avoidance and evasion may potentially arise. A few examples illustrate these points:

- In the first example, a profitable computer group in Country A buys "solid state drives" from its own subsidiary in Country B. The price the parent company in Country A pays its subsidiary company in Country B (the "transfer price") will determine how much profit the Country B unit reports and how much local tax it pays. If the parent pays the subsidiary a price that is lower than the appropriate arm's length price, the Country B unit may appear to be in financial difficulty, even if the group as a whole shows a reasonable profit margin when the completed computer is sold.
- From the perspective of the tax authorities, Country A's tax authorities might agree with the profit reported at their end by the computer group in Country A, but their Country B counterparts may not agree — they may not have the expected profit to tax on their side of the operation. If the computer company in Country A bought its drives from an independent company in Country B under comparable circumstances, it would pay the market price, and the supplier would pay taxes on its own profits in the normal way. This approach gives scope for the parent or subsidiary, whichever is in a low-tax jurisdiction, to be shown making a higher profit by fixing the transfer price appropriately and thereby minimizing its tax incidence.
- Accordingly, when the various parts of the organization are under some form of common control, it may mean that transfer prices are not subject to the full play of market forces and the correct arm's length price, or at least an "arm's length range" of prices needs to be arrived at.

- In the next example, a high-end watch manufacturer in Country A distributes its watches through a subsidiary in Country B. It is assumed that the watch costs $1400 to make and it costs the Country B subsidiary $100 to distribute it. The company in Country A sets a transfer price of $1500 and the subsidiary in Country B retails the watch at $1600 in Country B. Overall, the company has thus made $100 in profit, on which it is expected to pay tax.
- However, when the company in Country B is audited by Country B's tax administration they notice that the distributor itself does not earn a profit: the $1500 transfer price plus the Country B unit's $100 distribution costs are exactly equal to the $1600 retail price. Country

B's tax administration considers that the transfer price should be set at $1400 so that Country B's unit shows the group's $100 profit that would be liable for tax.

- This poses a problem for the parent company, as it is already paying tax in Country A on the $100 profit per watch shown in its accounts. Since it is a multinational group it is liable for tax in the countries where it operates and in dealing with two different tax authorities it is generally not possible to just cancel one out against the other. So the MNE can end up suffering double taxation on the same profits where there are differences about what constitutes the appropriate transfer pricing.

B.1.1.8. A possible reason for associated entities charging transfer prices for intra-group trade is to measure the performance of the individual entities in a multinational group. The individual entities within a multinational group may be separate profit centres and transfer prices are required to determine the profitability of the entities. However not every entity would necessarily make a profit or loss in arm's length conditions. Rationally, an entity having a view to its own interests as a distinct legal entity would only acquire products or services from an associated entity if the purchase price was equal to, or cheaper than, prices being charged by unrelated suppliers. This principle applies, conversely, in relation to an entity providing a product or service; it would rationally only sell products or services to an associated entity if the sale price was equal to, or higher than, prices paid by unrelated purchasers. Prices should on this basis gravitate towards the so-called "arm's length price", the transaction price to which two unrelated parties would agree.

B.1.1.9. While the above explanation of transfer pricing sounds logical and simple enough, arriving at an appropriate transfer price may be a complex task particularly because of the difficulties in identifying and valuing intangibles transferred and/or services provided. For example, intangibles could be of various different types such as industrial assets like patents, trade types, trade names, designs or models, literary and artistic property rights, know-how or trade secrets, which may or may not be reflected in the accounts. There are thus many complexities involved in dealing with transfer pricing in cross-border transactions between MNE entities.

B.1.1.10. Transfer pricing is a term that is also used in economics, so it is useful to see how economists define it. In business economics a transfer price is considered to be the amount that is charged by a part or segment of an organization for a product, asset or service that it supplies to another part or segment of the same organization. This definition is therefore consistent with the approach described above.

B.1.2. Basic Issues Underlying Transfer Pricing

B.1.2.1. Transfer prices serve to determine the income of both parties involved in the cross-border transaction. The transfer price therefore influences the tax base of the countries involved in cross-border transactions.

B.1.2.2. In any cross-border tax scenario, the parties involved are the relevant entities of the MNE group along with the tax authorities of the countries involved in the transaction. When one country's tax authority adjusts the profit of a member of the MNE group, this may have an effect on the tax base of another country. In other words, cross-border tax situations involve issues related to jurisdiction, allocation of income and valuation.

B.1.2.3. The key jurisdiction issues are: which government should tax the income of the group entities engaged in the transaction, and what happens if both governments claim the right to tax the same income? If the tax base arises in more than one country, should one of the governments give tax relief to prevent double taxation of the relevant entities' income, and if so, which one?

B.1.2.4. An added dimension to the jurisdictional issue is that of the motivation for transfer pricing manipulation, as some MNEs engage in practices that seek to reduce their overall tax bills. This may involve profit shifting through non-arm's length transfer pricing in order to reduce the aggregate tax burden of the MNE. However, while reduction of taxes may be a motive influencing the MNE in setting transfer prices for intra-group transactions, it is not the only factor that determines transfer pricing policies and practices.

B.1.2.5. The aim of non-arm's length transfer pricing in such cases is usually to reduce an MNE's worldwide taxes. This can be achieved by shifting profits from associated entities in higher tax countries to associated entities in relatively lower tax countries through either under-charging or over-charging the associated entity for intra-group trade. For example, if the parent company in an MNE group has a tax rate in the residence country of 30 percent, and has a subsidiary resident in another country with a tax rate of 20 percent, the parent may have an incentive to shift profits to its subsidiary to reduce its tax rate on these amounts from 30 percent to 20 percent. This may be achieved by the parent being over-charged for the acquisition of property and services from its subsidiary.

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

B.1.2.7. A further motivation for an MNE to engage in such practices is to use a tax benefit, such as a tax loss, in a jurisdiction in which it operates. This may be either a current year loss or a loss that has been carried forward from a prior year by an associated company. In some cases an international enterprise may wish to take advantage of an associated company's tax losses before they expire, in situations where losses can only be carried forward for a certain number of years. Even if there are no restrictions on carrying forward tax losses by an associated company, the international enterprise has an incentive to use the losses as quickly as possible. In other words profits may sometimes be shifted to certain countries in order to obtain specific tax benefits.

B.1.2.8. MNEs are global structures which may share common resources and overheads. From the perspective of the MNE these resources need to be allocated with maximum efficiency in an optimal manner.

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

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

B.1.2.11. Mere allocation of income and expenses to one or more members of the MNE group is not sufficient; the income and expenses must also be *valued*. A key issue of transfer pricing is therefore the valuation of intra-group transfers.

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

B.1.2.13. International tax issues, especially transfer pricing related issues, throw open a number of challenges, the complexity and magnitude of which are often especially daunting for smaller tax administrations.

B.1.2.14 One such complex yet pressing issue, especially given the exponential rise of the digital economy, is arriving at the appropriate arm's-length price for transactions involving intangibles. Intangibles are often unique, mobile and difficult to value and this presents unique problems for taxpayers and tax authorities alike.

B.1.2.15 Another set of challenges involve transfer pricing issues related to business restructuring and intra-group services. Transfer pricing documentation requirements for MNE's represent one more key focus area given the evolution of stringent documentation standards, including country-by-country reporting, not to mention the increasing information exchange between governments on international transactions.

B.1.2.16 All these basic and critical transfer pricing issues are addressed in detail in this Manual in separate chapters.

B.1.2.17 Overall, it should be amply clear that transfer pricing rules are essential for countries in order to protect their tax base, to eliminate double taxation and to enhance cross-border trade. For developing countries, transfer pricing rules are essential to provide a climate of certainty and an environment for increased cross-border trade while at the same time ensuring that the country is not losing out on critical tax revenue. Transfer pricing is thus of paramount importance and hence detailed transfer pricing rules are essential.

B.1.3. Evolution of Transfer Pricing

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

B.1.3.2. The OECD Transfer Pricing Guidelines (OECD Guidelines) as amended and updated, were first published in 1995; this followed previous OECD reports on transfer pricing in 1979 and 1984. The OECD Guidelines represent a consensus among OECD Members, mostly developed countries, and have largely been followed in domestic transfer pricing regulations of these countries. Another transfer pricing framework of note which has evolved over time is represented by the USA Transfer Pricing Regulations (26 USC 482).

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

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

B.1.3.5. Parent companies of large MNE groups usually have intermediary or sub-holdings in several countries around the world. From a management perspective, the decision-making in MNE groups may range from highly centralized structures to highly decentralized structures with profit responsibility allocated to individual group members. Such group structures typically include:

- Research and development (R&D) and services that may be concentrated in centres operating for the whole group or specific parts of the group;
- Intangibles, developed by entities of the MNE group; these may be concentrated around certain group members;
- Finance and "captive insurance companies"[3] which may operate as insurers or internal finance companies; and
- Production units, where the production or assembly of final products may take place in many countries around the world.

B.1.3.6. The on-going and continuous relocation of the production of components and finished products to particular countries; the rise of many new economies in the developing countries with their infrastructure, skilled labour, low production costs, conducive economic climate etc;

[3] Insurance companies within a group having the specific objective of insuring group risks.

the round-the-clock trading in financial instruments and commodities; and the rise of e-commerce and Internet-based business models are a few of the many reasons why transfer pricing has become such a high profile issue over the last couple of decades.

B.1.3.7. Other considerations have also had an impact on the current importance of transfer pricing. Some developed countries have tightened their transfer pricing legislation to address the issue of foreign enterprises active in their countries paying lower tax than comparable domestic groups. Consequently some developing countries have introduced equally exhaustive transfer pricing regulations in their countries to keep their tax bases intact. Other developing countries are recognizing that they need to effectively address the challenges of transfer pricing in some way.

B.1.3.8. Countries with less sophisticated tax systems and administrations have run the risk of absorbing the effect of stronger enforcement of transfer pricing in developed countries and in effect paying at least some of the MNEs' tax costs in those countries. In order to avoid this, many countries have introduced new transfer pricing rules.

B.1.3.9. The OECD Committee on Fiscal Affairs continues to monitor developments in transfer pricing, in particular developments in the use of profit-based methods, and in comparability matters. The recent thrust of the OECD has been studying, along with G20 countries, the current international taxation rules to identify weakness which may result in opportunities for Base Erosion and Profit Sharing (BEPS). In September 2013, the OECD launched the Action Plan on BEPS initiative which identified 15 actions aimed at providing new or reinforced international standards and measures to help countries tackle BEPS. The OECD BEPS initiative released 7 preliminary reports in 2014 and followed it with the release of a final package of 15 reports, one for each Action Plan, at the G20 Finance Ministers meeting in October 2015. The Action Plans provide Model provisions to prevent treaty abuse; call for standardised Country-by-Country Reporting in terms of documentation requirements; elucidate a peer review process for addressing harmful tax practices; endorse a minimum standard to secure progress on dispute resolution and make many other such recommendations.

B.1.3.10 While the OECD BEPS initiative, theoretically, is aimed at revamping international tax standards to keep pace with the changing global business environment, the practical implementation of such BEPS measures is dependent on the individual countries making necessary changes to their domestic laws as well as modifying treaty provisions with other countries and doing all of this in a co-ordinated manner - which is yet to happen.

B.1.3.11 It is to be noted that with respect to the OECD TP Guidelines, these have emerged out of Article 9 of the OECD Model Convention; they have also been applied in the context of the UN Model Double Tax Convention. However, developing countries have found it very difficult to implement such guidelines in practice. There are presently five different prescribed transfer pricing methods (see Part B.3.) that may be used under the OECD Guidelines in various situations to arrive at an arm's length price. However, while these methods may be able to provide a computation of the arm's length price (i.e., an appropriate transfer price) within the MNE, in practice disagreements between tax authorities in applying these methods may result in taxable profits between two MNEs being either more than 100 percent or less than 100 percent of actual combined profits. This situation could arise as a result of adjustments carried out by one tax authority without corresponding adjustments by the tax authority in the other country, where such adjustments are not endorsed in the relevant double taxation treaty.

B.1.3.12. The European Commission has also developed proposals on income allocation to members of MNEs active in the European Union (EU). Some of the approaches considered have included the possibility of a "common consolidated corporate tax base (CCTB)" and "home state taxation".[4] Under both options transfer pricing would be replaced by formulary apportionment, whereby taxing rights would be allocated between countries based upon the apportionment of the European business activity of an MNE conducted in those countries. Apportionment would be under an agreed formula, based upon some criteria of business activity such as some combination of sales, payroll, and assets. In recent years, the EU Joint Transfer Pricing Forum[5] has developed proposals to improve transfer pricing dispute resolution (Mutual Agreement Procedure, arbitration and Advance Pricing Arrangements), and a proposal to harmonize transfer pricing documentation requirements. The proposals on EU transfer pricing documentation requirements and on the implementation of the EU Arbitration Convention have been adopted as "Codes of Conduct" by the EU Council. The EU Council also issued, on 17 May 2011, some guidelines on low-value-adding intra-group services; they are endorsed on the basis that their implementation should contribute to reducing tax disputes. The European Commission has also published a Communication recently on a "Fair and Efficient Corporate Tax System in the European Union" which aims to set out how the OECD G20/BEPS measures can be implemented within the EU.

B.1.3.13. The United Nations for its part published an important report on "International Income Taxation and Developing Countries" in 1988.[6] The report discusses significant opportunities for transfer pricing manipulation by MNEs to the detriment of developing country tax bases. It recommends a range of mechanisms specially tailored to deal with the particular intra-group transactions by developing countries. The United Nations Conference on Trade and Development (UNCTAD) also issued a major report on Transfer Pricing in 1999.[7]

B.1.3.14. The United Nations is again taking a leadership role, through this Transfer Pricing Manual, in trying to arrive at updated global transfer pricing guidance which can be used by countries all over the world in developing and implementing their transfer pricing regulations.

B.1.4. Concepts in Transfer Pricing

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

"Where:

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

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

[6] Available from unctc.unctad.org/data/e88iia6b.pdf

[7] Available from unctad.org/en/pages/PublicationArchive.aspx?publicationid-348

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

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

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of these conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly".[8]

B.1.4.2. In other words, the transactions between two related parties must be based on the arm's length principle (ALP). The term "arm's length principle" itself is not a term specifically used in Article 9, but is well accepted by countries as encapsulating the approach taken in Article 9,[9] with some differing interpretations as to what this means in practice. The principle set out above in the UN Model has also been reiterated in the OECD Model Tax Convention and the OECD Guidelines as supplemented and amended.

B.1.4.3. Thus, the arm's length principle is the accepted guiding principle in establishing an acceptable transfer price under Article 9 of the UN Model. The arm's length principle by itself is not new; it has its origins in contract law to arrange an equitable agreement that will stand up to legal scrutiny, even though the parties involved may have shared interests.

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

B.1.4.5. The rationale for the arm's length principle itself is that because the market governs most of the transactions in an economy it is appropriate to treat intra-group transactions as equivalent to those between independent entities. Under the arm's length principle, intra-group transactions are tested and may be adjusted if the transfer prices are found to deviate from comparable arm's length transactions. The arm's length principle is argued to be acceptable to everyone concerned as it uses the marketplace as the norm.

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

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

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

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

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

- Assume a Corporation P (parent) manufactures automobile seats in Country A, sells the finished seats to its Subsidiary S in Country B which then sells those finished seats in Country B to unrelated parties (say, the public at large). In such a case S's taxable profits are determined by the sale price of the seats to the unrelated parties minus the price at which the seats were obtained from its parent corporation (cost of goods sold in the accounts of S, in this case the transfer price) and its expenses other than the cost of goods sold.
- If Country A where the seats are manufactured has a tax rate much lower than the tax rate in Country B where the seats are sold to the public at large, i.e. to unrelated parties, then perhaps Corporation P would have an incentive to book as much profit as possible in Country A and to this end show a very high sales value (or transfer price) of the seats to its Subsidiary S in Country B. If the tax rate was higher in Country A than in Country B then the corporation would have an incentive to show a very low sales value (or transfer price) of the seats to its Subsidiary S in Country B and concentrate almost the entire profit in the hands of Country B.
- This is a clear example that when associated enterprises deal with each other their commercial or financial relations may not be directly affected by market forces but may be influenced more by other considerations. The arm's length principle therefore seeks to determine whether the transactions between related taxpayers (in this case Corporation P and its Subsidiary S) are appropriately priced to reflect their true tax liability by comparing them to similar transactions between unrelated taxpayers at arm's length.

B.1.4.9 Intangibles present a unique challenge to applying the arm's-length principle to arrive at the appropriate transfer price as in practice they may be tough to identify, value and find comparables for. A whole host of transfer pricing issues has opened up due to the rapid increase in the use of intangibles by MNE's.

B.1.4.10. 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 factors range from government policies and regulations to cash-flows of the entities in the MNE group.

B.1.4.11. 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 to the arm's length transaction; any such adjustment may arise irrespective of the contractual terms between the entities. Another incorrect assumption, often made in practice, is that the commercial or financial relations between associated enterprises and in the marketplace will without fail be different and always at odds with each other.

B.1.4.12. In many cases the MNEs themselves may have an incentive to set an arm's length price for their intra-group transactions so as to judge the true performance of their underlying entities.

B.1.4.13. Overall, the underlying idea behind the arm's length principle is the attempt to place transactions, both uncontrolled and controlled, on equal terms with respect to the tax advantages (or disadvantages) that they create. The arm's length principle has been widely accepted and has found its way into most transfer pricing legislation across the world.

B.1.4.14. An alternative to the arm's length principle might be a Global Formulary Apportionment Method which would allocate the global profits of an MNE group amongst the associated enterprises on the basis of a multi-factor weighted formula (using factors such as property, payroll and sales for example, or such other factors as may be defined when adopting the formula). A formulary apportionment approach is currently used by some states of the USA, cantons of Switzerland and provinces of Canada. Also, the Brazilian transfer pricing rules[10] set out a maximum ceiling on the expenses that may be deducted for tax purposes in respect of imports and lay down a minimum level for the gross income in relation to exports, effectively using a set formula to allocate income to Brazil. The EU is also considering a formulary approach, at the option of taxpayers, to harmonize its corporate taxes under the Common Consolidated Corporate Tax Base (CCCTB) initiative.

Applying the arm's length principle

B.1.4.15. The process to arrive at the appropriate arm's length price typically involves the following processes or steps:

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

[10] See the paper on the Brazilian approach in Part D.2.

B.1.4.16. The above processes are discussed in detail in Part B.2 of this Manual on Comparability Analysis.

B.1.4.17. The transfer pricing methods are set forth in more detail at 1.5. below, and are dealt with comprehensively at Part B.3. It is, however, important to note at the outset that there is no single transfer pricing method which is generally applicable to every possible situation.

B.1.4.18. Computing an arm's length price using transfer pricing analysis is a complex task. The task requires effort and goodwill from both the taxpayer and the tax authorities in terms of documentation, groundwork, analysis and research; comparables play a critical role. This Manual seeks to assist developing countries in that task as much as possible, but it has to be recognized that the task will rarely be a simple one.

B.1.5. Transfer Pricing Methods

B.1.5.1. The key question is how to apply the arm's length principle in practice to determine the arm's length price of a transaction. Several acceptable transfer pricing methods exist, providing a conceptual framework for the determination of the arm's length price. No single method is considered suitable in every situation and the taxpayer must select the method that provides the best estimate of an arm's length price for the transaction in question.

B.1.5.2. All these transfer pricing methods rely directly or indirectly on the comparable profit, price or margin information of similar transactions. This information may be an "internal comparable" based on similar uncontrolled transactions between the entity and a third party or an "external comparable" involving independent enterprises in the same market or industry.

B.1.5.3. The six major transfer pricing methods (discussed in detail at B.3 of this Manual) are as follows:

Transaction-based methods

B.1.5.4. **Comparable Uncontrolled Price (CUP)** The CUP Method compares the price charged for a property or service transferred in a controlled transaction to the price charged for a comparable property or service transferred in a comparable uncontrolled transaction in comparable circumstances.

B.1.5.5. **Resale Price Method (RPM)** The Resale Price Method is used to determine the price to be paid by a reseller for a product purchased from an associated enterprise and resold to an independent enterprise. The purchase price is set so that the margin earned by the reseller is sufficient to allow it to cover its selling and operating expenses and make an appropriate profit.

B.1.5.6. **Cost Plus (C+ or CP)** The Cost Plus Method is used to determine the appropriate price to be charged by a supplier of property or services to a related purchaser. The price is determined by adding to costs incurred by the supplier an appropriate gross margin so that the supplier will make an appropriate profit in the light of market conditions and functions performed.

Profit-based methods

B.1.5.7. Two classes of transactional profit methods are recognized by the US Section 482 IRS regulations and the OECD Guidelines. These may be categorized as *profit-comparison methods* (Transactional Net Margin Method or TNMM/Comparable Profits Method or CPM) and *profit-split methods*.

B.1.5.8. **Profit comparison methods (TNMM/CPM)** These methods seek to determine the level of profits that would have resulted from controlled transactions by reference to the return realized by the comparable independent enterprise. The TNMM determines the net profit margin relative to an appropriate base realized from the controlled transactions by reference to the net profit margin relative to the same appropriate base realized from uncontrolled transactions.

B.1.5.9. **Profit-split methods** Profit-split methods take the combined profits earned by two related parties from one or a series of transactions and then divide those profits using an economically valid defined basis that aims at replicating the division of profits that would have been anticipated in an agreement made at arm's length. Arm's length pricing is therefore derived for both parties by working back from profit to price.

B.1.5.10 **Sixth method (Commodity Rule)** The Commodity Rule, also known as the 'sixth method' is especially applicable to commodity transactions. It is in use, with many variations thereof, by several developing countries for arriving at the arm's-length price of import and export transactions of commodities such as grains, oil and oilseeds, oil and gas, mining and fishing.

B.1.5.11 The workings of the Commodity Rule may resemble the Comparable Uncontrolled Price (CUP) method. The fact pattern addressed by this method is, for example, where one of the associated enterprises engaged in exporting commodities invoices an associated enterprise in relation to the sale of the commodities though it ships the commodities to a party (and jurisdiction) different from the associated enterprise that it (the seller) invoiced. Furthermore, the actual shipment date is usually at a later point in time than date of the original sale between the associated enterprises and the intercompany invoice date. Typically, the associated enterprise being invoiced is a trading entity that carries title to the shipped goods for a limited period of time and the subsequent shipment is to a destination determined by a third party that has bought the commodities from the associated trader (not to the residence of the associated trading entity). There are a number of permutations of this Commodity Rule observed in practice related to different aspects that make up the rule. Chapter B.3. deals with this sixth method, namely the Commodity Rule, in detail.

B.1.5.12 The first three methods above (i.e. CUP, RPM and CM) are often called "traditional transaction" methods and the last two are called "transactional profit methods" or "profit-based" methods. As noted above, there is growing acceptance of the practical importance of the profit-based methods. All these methods are widely accepted by national tax authorities. It must be noted that the US regulations provide for the use of additional methods applicable to global dealing operations like the Comparable Uncontrolled Transaction (CUT) Method. This method is similar to the CUP in that it determines an arm's length royalty rate for an intangible by comparison to uncontrolled transfers of comparable intangible property in comparable circumstances.

B.1.5.13 Other unspecified methods may be used to evaluate whether the amount charged in a controlled transaction is at arm's length. Any such method should be applied in accordance with the reliability considerations used to apply the specified methods described above. An unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. In establishing whether a controlled transaction achieves an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. These methods are discussed in detail at Part B.3 of this Manual.

B.1.6. Special Issues Related to Transfer Pricing

Documentation requirements

B.1.6.1. Generally, a transfer pricing exercise involves various steps such as:

- Gathering background information;
- Industry analysis;
- Comparability analysis (which includes functional analysis);
- Selection of the method for determining arm's length pricing; and
- Determination of the arm's length price.

B.1.6.2. At every stage of the transfer pricing process, varying degrees of documentation are necessary, such as information on contemporaneous transactions. One pressing concern regarding transfer pricing documentation is the risk of overburdening the taxpayer with disproportionately high costs in obtaining relevant documentation or in an exhaustive search for comparables that may not exist. Ideally, the taxpayer should not be expected to provide more documentation than is objectively required for a reasonable determination by the tax authorities of whether or not the taxpayer has complied with the arm's length principle. Cumbersome documentation demands may affect how a country is viewed as an investment destination and may have particularly discouraging effects on small and medium-sized enterprises (SMEs).

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

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

2. *transaction-specific documents* (for example the details of each international transaction, functional analysis of the taxpayer and associated enterprises, record of uncontrolled transactions for each international transaction etc); and
3. *computation-related documents* (for example the nature of each international transaction and the rationale for selecting the transfer pricing method for each international transaction, computation of the arm's length price, factors and assumptions influencing the determination of the arm's length price etc).

B.1.6.4. The domestic legislation of some countries may also require "contemporaneous documentation". Such countries may consider defining the term "contemporaneous" in their domestic legislation. The term "contemporaneous" means "existing or occurring in the same period of time". Different countries have different views about how the word "contemporaneous" is to be interpreted with respect to transfer pricing documentation. Some believe that it refers to using comparables that are contemporaneous with the transaction, regardless of when the documentation is produced or when the comparables are obtained. Other countries interpret contemporaneous to mean using only those comparables *available* at the time the transaction occurs.

B.1.6.5 An important development in the documentation requirements for transfer pricing purposes is the recent effort to establish a uniform documentation standard. In connection with this, in 2015, the G20/OECD BEPS Project issued guidance which set out a standardised three-tier approach to transfer pricing documentation. It suggests that the documentation should include (i) a Master File containing general information about the MNE group relevant to all MNE group members; (ii) a Local File referring specifically to material transactions of the MNE group members resident in the local jurisdiction and setting out the taxpayer's transfer pricing methodology and (iii) a Country-by-Country- Report ("CbC Report") containing information relating to global allocation among the MNE's taxing jurisdictions and taxes paid along with economic activity indicators in the MNE group. The Final BEPS Report included agreed guidance on implementing the new documentation and reporting rules.

B.1.6.6 These OECD/G20 BEPS guidelines relating to documentation cannot be automatically assumed to be adopted in full by developing countries. The guidelines have to be analyzed as to how in practice they may be applicable in a developing country context and the constraints that may exist in the MNE and the tax administrations in developing countries have to be kept in mind. Developing countries may however assume that in future MNEs will prepare the Master File and that the large MNEs will prepare the CbC Report. The key question for developing countries would likely be whether the Local File envisioned in these BEPS guidelines should be adopted without modification in the local country.

Intangibles

B.1.6.7. Intangibles (literally meaning assets that cannot be touched) encompass something which is neither a physical nor a financial asset, which is capable of being owned or controlled for commercial purposes, whose use or transfer would be compensated had it occurred between independent enterprises in comparable circumstances. This definition is the same as that found in the OECD/G20 Action Plan 8 Report which looks at transfer pricing issues involving intangibles.

B.1.6.8. A common distinction is made between legally registered and non-registered intangibles. Another category of intangibles are the 'soft' intangibles which refers to items such as network effects, internal procedures and best practices which may not be legally registered and may not be separately traded between third parties though they might form a key part of the success or failure of companies in competitive markets

B.1.6.9. For the purpose of transfer pricing issues, intangibles are typically divided into “trade intangibles” and “marketing intangibles”. Trade intangibles such as know-how relate to the production of goods and the provision of services and are typically developed through research and development. Marketing intangibles refer to intangibles such as trade names, trademarks and client lists that aid in the commercial exploitation of a product or service.

B.1.6.10. For transfer pricing, whether a particular intangible is 'unique and valuable' is an important, separate concept and is measured by whether such intangible is not present in otherwise comparable uncontrolled transactions and whether it leads to significant expected premium value in business operations

B.1.6.11. There are many types of intangibles – including “market features” i.e. specific non-local characteristics of a certain market which may affect arm's-length, “goodwill” or “ongoing concern value”, “group synergies”, existence of a qualified and skilled “workforce” which may all meet the criteria of being considered an intangible depending on the facts and circumstances of the case.

B.1.6.12. The analysis of transactions involving intangibles is thus quite complicated and typically, at the fact-finding phase itself, one must consider the **d**evelopment (or **a**cquisition from third-parties) of the intangibles, the **e**nhancement, **m**aintenance, **p**rotection and **e**xploitation of intangibles – together collectively known as “DAEMPE” contributions.

B.1.6.13. The legal ownership and contractual terms also form the basis for analysis of intangibles, and their transfer, between associated enterprises. Legal ownership of intangibles does not by itself confer a right to ultimately retain returns derived at MNE level. What is relevant for transfer pricing is to determine with accuracy the valuable contributions by the associated enterprises in terms of functions performed, risks assumed and assets utilized in the context of value creation.

B.1.6.14. Furthermore, the question of who should bear the difference between *ex ante* returns and actual *ex post* returns depends on the extent to which the relevant risk is assumed by the parties and requires proper delineation of the transaction involving intangibles.

B.1.6.15. It suffices to say that the arm’s length principle often becomes very difficult to apply to intangibles. The multitude of issues involved in the transfer pricing of transactions involving intangibles has been dealt with in detail in Chapter B.5, of this Manual.

B.1.6.16. The Profit Split Method is typically used in cases where both parties to the transaction make unique and valuable contributions. However care should be taken to identify the intangibles in question. Experience has shown that the transfer pricing methods most likely to prove useful in matters involving transfers of intangibles or rights in intangibles are the CUP Method and the Transactional Profit Split Method. Valuation techniques can be useful tools in some circumstances.

Business restructuring

B.1.6.17. There is no universally accepted definition for business restructuring but in the transfer pricing scenario, it is considered to be cross-border redeployment of functions, assets and risks to which a profit/loss potential may be attached. Business restructuring has a very wide ambit; typically it may concern the conversion of local full-fledged manufacturers into contract manufacturers; the adoption of a limited-risk distribution structure by a distributor; or the transfer of intangibles to principal companies abroad.

B.1.6.18. The general rule is that businesses may organize their activities in the manner they see fit. The key issue becomes whether such restructuring is undertaken in a manner consistent with the arm's-length principle.

B.1.6.19. For developing countries, it is important to ensure that the arm's-length principle is applied neutrally i.e. not distinguishing whether one of the entities in the restructuring is in a developing country. There might be implementation issues with respect to the lack of comparables in a developing country but that should not affect the fact that the transfer pricing effects of a business restructuring should be the same regardless of where the reorganization actually takes place.

B.1.6.20. Part B.7 deals with the various aspects of the transfer pricing of business restructurings in more detail.

Intra-group services

B.1.6.21. An intra-group service, as the name suggests, is a service provided by one enterprise to another in the same MNE group. For a service to be considered an intra-group service it must be similar to a service which an independent enterprise in comparable circumstances would be willing to pay for in-house or else perform by itself. If not, the activity should not be considered as an intra-group service under the arm’s length principle. The rationale is that if specific group members do not need the activity and would not be willing to pay for it if they were independent, the activity cannot justify a payment. Further, any incidental benefit gained solely by being a member of an MNE group, without any specific services provided or performed, should be ignored.

B.1.6.22. In the case of centralized services, each associated enterprise within the MNE group receiving a benefit from a centralized service has to be charged at the arm's length price for the services. These centralized services may be part of an associated enterprise's main business activity or it may be low-margin services, for example administrative services. Different charging methods may be used appropriately for such low and high-margin services.

B.1.6.23. An arm's length price for intra-group services may be determined directly or indirectly — in the case of a direct charge, the CUP Method could be used if comparable services are provided in the open market. In the absence of comparable services the Cost Plus Method could be appropriate.

B.1.6.24. If a direct charge method is difficult to apply, the MNE may apply the charge indirectly by cost sharing, by incorporating a service charge or by not charging at all. Such methods would usually be accepted by the tax authorities only if the charges are supported by foreseeable benefits for the recipients of the services, the methods are based on sound accounting and commercial principles and they are capable of producing charges or allocations that are commensurate with the reasonably expected benefits to the recipient. In addition, tax authorities might allow a fixed charge on intra-group services under safe harbour rules or a presumptive taxation regime, for instance where it is not practical to calculate an arm's length price for the performance of services and tax accordingly.

B.1.6.25. A separate chapter, Part B.4 deals with the issues related to intra-group services.

Cost-contribution agreements

B.1.6.26. Cost-contribution agreements (CCAs) may be formulated among group entities to jointly develop, produce or obtain rights, assets or services. Each participant bears a share of the costs and in return is expected to receive *pro rata* (i.e. proportionate) benefits from the developed property without further payment. Such arrangements tend to involve research and development or services such as centralized management, advertising campaigns etc.

B.1.6.27. In a CCA there is not always a benefit that ultimately arises; only an expected benefit during the course of the CCA which may or may not ultimately materialize. The interest of each participant should be agreed upon at the outset. The contributions are required to be consistent with the amount an independent enterprise would have contributed under comparable circumstances, given these expected benefits. The CCA is not a transfer pricing method; it is a contract. However it may have transfer pricing consequences and therefore needs to comply with the arm's length principle.

B.1.6.28. A CCA will fail the arm's-length test if the contributions of the participants are inconsistent with their share of benefits, expected or realized. If a participant's share of the benefits is inadequate in comparison to its contribution, a tax authority may make an adjustment to rectify the imbalance. In certain cases the CCA terms might differ from the economic reality of a CCA and the entire CCA, or some terms thereof, may be disregarded by a tax authority.

B.1.6.29. A separate chapter, Part B.6, deals with the issues related to cost-contribution arrangements

Use of "secret comparables"

B.1.6.30. There is often concern expressed by enterprises over aspects of data collection by tax authorities and its confidentiality. Tax authorities need to have access to very sensitive and highly confidential information about taxpayers, such as data relating to margins, profitability, business contacts and contracts. Confidence in the tax system means that this information needs to be treated very carefully, especially as it may reveal sensitive business information about that taxpayer's profitability, business strategies and so forth.

B.1.6.31. Using a secret comparable generally means the use of information or data about a taxpayer by the tax authorities to form the basis of risk assessment or a transfer pricing audit of another taxpayer. That second taxpayer is often not given access to that information as it may reveal confidential information about a competitor's operations.

B.1.6.32. Caution should be exercised in permitting the use of secret comparables in the transfer pricing audit unless the tax authorities are able to (within limits of confidentiality) disclose the data to the taxpayer so as to assist the taxpayer to defend itself against an adjustment. Taxpayers may otherwise contend that the use of such secret information is against the basic principles of equity, as they are required to benchmark controlled transactions with comparables not available to them — without the opportunity to question comparability or argue that adjustments are needed.

B.1.7. Transfer Pricing in Domestic Law

Introduction (Move material to Section B.8 – Legislative Design Principles)

B.1.7.1. Article 9 ("Associated Enterprises") of tax treaties typically only regulates the basic conditions for adjustment of transfer pricing and corresponding adjustments in case of double taxation. The Article advises the application of the arm's length principle but does not go into the particulars of transfer pricing rules. It is generally understood that Article 9 is not "self-executing" as to domestic application — it does not create a transfer pricing regime in a country where such a regime does not already exist.

B.1.7.2. It should be recognized that transfer pricing regimes are creatures of domestic law and each country is required to formulate detailed domestic legislation to implement transfer pricing rules. Many countries have passed such domestic transfer pricing legislation which typically tends to limit the application of transfer pricing rules to cross-border related party transactions only.

B.1.7.3. It is important to note that the definition of an "associated enterprise" is based on domestic circumstances and hence varies, to some extent, amongst different countries. For example, a majority of countries employ a hybrid qualification for such taxpayers, namely a mixture of qualification by minimum shareholding (generally equal to or more than 50 percent) and effective control by any other factors (dependency in financial, personnel and trading conditions). *De minimis* criteria for the value of related party transactions may also exist. In other words, some transactions may be considered small enough that the costs of compliance and collection do not justify applying the transfer pricing rules, but this should not allow what are in reality larger transactions to be split into apparently smaller transactions to avoid the operation of the law.

B.1.7.4. It must be noted that transfer pricing being essentially domestic regulation has a long history, and international consistency of transfer pricing rules is beneficial not only regarding the basic structure of taxable persons and events but also in the manner of application of the arm's length principle. However, it is ultimately for each country to adopt an approach that works in its domestic legal and administrative framework, and is consistent with its treaty obligations.

Safe harbours

B.1.7.5. There are countries which have "safe harbour" rules providing that if a taxpayer meets certain criteria it is exempt from the application of a particular rule, or at least exempt from scrutiny as to whether the rule has been met. The intention is to increase taxpayer certainty and reduce taxpayer compliance costs, but also to reduce the administration's costs of collection, as well as allowing the administration to concentrate scarce audit and other resources on those cases where more is likely to be at stake in terms of non-compliance and revenue.

B.1.7.6. Safe harbour rules are provisions whereby if a taxpayer's reported profits are within a certain range or percentage or under a certain amount, the taxpayer is not required to follow a complex and burdensome rule, such as applying the transfer price methodologies. They may only be used by the taxpayers at their option. There are some risks to safe harbours, such as arbitrariness in setting parameters and range; equity and uniformity issues; incompatibility with the arm's length principle; opportunities for tax planning and tax evasion and potential risk of double taxation. In any case, consistent with the purpose of this Manual, introducing a safe harbour rule should involve analysis of whether, in a broad sense, the administrative and simplification benefits of a safe harbour outweigh the potential costs of applying something other than the arm's length principle.

Controlled foreign corporation provisions

B.1.7.7. Some countries operate Controlled Foreign Corporation (CFC) rules. CFC rules are designed to prevent tax being deferred or avoided by taxpayers using foreign corporations in which they hold a controlling shareholding in low-tax jurisdictions and "parking" income there. CFC rules treat this income as though it has been repatriated and it is therefore taxable prior to actual repatriation. Where there are CFC rules in addition to transfer pricing rules, an important question arises as to which rules have priority in adjusting the taxpayer's returns. Due to the fact that the transfer pricing rules assume all transactions are originally conducted under the arm's length principle, it is widely considered that transfer pricing rules should have priority in application over CFC rules. After the application of transfer pricing rules, countries can apply the CFC rules on the retained profits of foreign subsidiaries.

Thin capitalization

B.1.7.8. When the capital of a company is made up of a much greater contribution of debt than of equity, it is said to be "thinly capitalized". This is because it may be sometimes more advantageous from a taxation viewpoint to finance a company by way of debt (i.e., leveraging) rather than by way of equity contributions as typically the payment of interest on the debts may be deducted for tax purposes whereas distributions are non-deductible dividends. To prevent tax avoidance by such excessive leveraging, many countries have introduced rules to prevent thin capitalization, typically by prescribing a maximum debt to equity ratio. Country tax administrations often introduce rules that place a limit on the amount of interest that can be deducted in calculating the measure of a company's profit for tax purposes. Such rules are designed to counter cross-border shifting of profit through excessive debt, and thus aim to protect a country's tax base. From a policy perspective, failure to tackle excessive interest payments to associated enterprises gives MNEs an advantage over purely domestic businesses which are unable to gain such tax advantages.

Documentation

B.1.7.9. Another important issue for implementing domestic laws is the documentation requirement associated with transfer pricing. Tax authorities need a variety of business documents which support the application of the arm's length principle by specified taxpayers. However, there is some divergence of legislation in terms of the nature of documents required, penalties imposed, and the degree of the examiners' authority to collect information when taxpayers fail to produce such documents. There is also the issue of whether documentation needs to be "contemporaneous", as noted above.

B.1.7.10. In deciding on the requirements for such documentation there needs to be, as already noted, recognition of the compliance costs imposed on taxpayers required to produce the documentation. Another issue is whether the benefits, if any, of the documentation requirements from the administration's view in dealing with a potentially small number of non-compliant taxpayers are justified by a burden placed on taxpayers generally. A useful principle to bear in mind would be that the widely accepted international approach which takes into account compliance costs for taxpayers should be followed, unless a departure from this approach can be clearly and openly justified because of local conditions which cannot be changed immediately (e.g. constitutional requirements or other overriding legal requirements). In other cases, there is great benefit for all in taking a widely accepted approach. See further Part C.2 of this Manual which details the most widely accepted approaches.

Advance pricing agreements

B.1.7.11. Recently, multinational businesses have often depended on Advance Pricing Agreements (APAs) (or "Advance Pricing Arrangements", as some countries prefer) with tax authorities, especially in the framework of the Mutual Agreement Procedure. These APAs are so named because pricing methodologies are agreed in advance in relation to certain types of transactions, often called the “covered transactions”. APAs provide greater certainty for the taxpayer on the taxation of certain cross-border transactions and are considered by the taxpayers as the safest way to avoid double taxation, especially where they are bilateral or multilateral. Many countries have introduced APA procedures in their domestic laws though these may have different legal forms. For example, in certain countries an APA may be a legally binding engagement between taxpayers and tax authorities, while in other countries it may be a more informal arrangement between the tax authorities and the taxpayer. The possible advantages and disadvantages of APAs for developing country administrations and taxpayers, including some implementation issues, are addressed in Part C.4.

Time limitations

B.1.7.12. Another important point for transfer pricing domestic legislation is the “statute of limitation” issue — the time allowed in domestic law for the tax administration to do the transfer pricing audit and make necessary assessments or the like. Since a transfer pricing audit can place heavy burdens on the taxpayers and tax authorities, the normal “statute of limitation” period for taking action is often extended compared with general domestic taxation cases. However, too long a period during which adjustment is possible leaves taxpayers in some cases with potentially very large financial risks. Differences in country practices in relation to time limitation may lead to double taxation. Countries should keep this issue of balance between the interests of the revenue and of taxpayers in mind when setting an extended period during which adjustments can be made.

Domestic transfer pricing rules and tax treaties

B.1.7.13. Both developed and developing countries need to have domestic transfer pricing rules to counter transfer pricing manipulation and also need the “associated enterprises” article of tax treaties (usually Article 9) which is relevant to avoidance and elimination of double taxation due to transfer pricing adjustments. One view is that the associated enterprises article of a tax treaty provides a separate and independent domestic basis for making transfer pricing adjustments. The contrary view is that tax treaties do not increase a country’s tax jurisdiction and consequently the associated enterprises article of a country’s tax treaties cannot provide a separate source of tax jurisdiction. The detail in such domestic laws will vary from country to country and will often vary depending on how advanced the country is in its transfer pricing journey.

B.1.7.14. One view is that a country’s tax jurisdiction, usually some mixture of residence and source-based taxation, is based on its domestic legislation and that when two countries enter into a tax treaty with each other they agree to mutually modify the exercise of their respective taxing rights to prevent double taxation. A tax treaty is in this respect a mechanism to allocate the taxing rights to prevent double taxation arising from the overlap of residence and source jurisdiction. Tax treaties operate by altering the operation of domestic tax law; by either excluding the operation of the domestic tax law of a treaty country or by requiring a treaty country to provide a credit against its domestic tax for tax paid in the other treaty country. The generally held view is that under a tax treaty a tax obligation exists if the requirements of the treaty country's domestic law and the tax treaty are both satisfied. The taxing powers of each treaty country are based on their respective domestic taxation law and may be limited but not expanded by the treaty. Also, treaties do not provide the necessary detail on how a transfer pricing regime will work in practice, such as the documentation required. As a consequence of these factors it is generally considered that a country with tax treaties should enact domestic transfer pricing measures rather than asserting that its treaties provide it with a power to make transfer pricing adjustments.

B.1.7.15. For transfer pricing measures to be effective, a tax jurisdiction must enforce them and ensure that taxpayers comply with the rules. If jurisdictions either do not enact transfer pricing measures or do not enforce those measures there is an incentive for taxpayers to ensure that intra-group transfer prices favour jurisdictions that enforce their rules. This may be described as taking the line of least resistance, but it does provide an incentive for developing jurisdictions to enact and enforce some form of transfer pricing rules to protect their revenue base.

B.1.7.16. That MNEs might use transfer prices to shift profits from lower tax countries to higher tax countries is a paradox, but happens in practice (e.g. to benefit from certain tax incentives in the high tax country or because there are losses in the high tax country that can be offset with profits from a lower tax country). MNEs may also have an incentive to shift profits to jurisdictions in which tax laws, such as transfer pricing rules, are not enforced. Transfer pricing is a "zero sum game" — a situation in which the "gain" of taxable profits by one jurisdiction must be matched by a "loss" by the other jurisdiction. Consequently some international enterprises might set their transfer prices to favour a jurisdiction expected to enforce its transfer pricing rules, in order to minimize the risk of transfer pricing adjustments and penalties in that jurisdiction. Moreover, transfer pricing disputes are generally time consuming and expensive.

B.1.8. Transfer Pricing in Treaties

UN and OECD Model Conventions: An overview(Move material to Section B.8 – Legislative Design Principles)

B.1.8.1. The OECD Model Convention[11] was first published in 1963 as a draft version. A final version was first published in 1977. This OECD work followed up some work already done by the League of Nations; and then after World War II by the United Nations. The United Nations produced a UN Model Convention for Treaties between Developed and Developing Nations in 1980, with a new version produced in 2001.[12] The UN Model Convention has now been further updated, and was launched as the 2011 update on 15 March 2012. The UN Model is in many respects similar to the OECD Model but the differences (such as preserving greater taxation rights to countries hosting investments) are very significant, especially for developing countries.

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

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

B.1.8.2. There has historically been a widespread view that the OECD Model was most appropriate for negotiations between developed countries and less suitable for capital importing or developing countries. In general, it can be said that the UN Model preserves more taxation rights to the source state (i.e. host state of investment) or capital-importing country than the OECD Model. The UN Model has been embraced by many developing states as the basis of their treaty policy. Some developed countries also adopt some UN Model provisions, and at times it has influenced changes to give aspects of the OECD Model a greater source country orientation.

Transfer pricing and the model conventions

B.1.8.3. Article 9 of the OECD Model is a statement of the arm's length principle and allows for profit adjustments if the actual price or the conditions of transactions between associated enterprises differ from the price or conditions that would be charged by independent enterprises under normal market commercial terms, i.e. an arm's length basis. It also requires that an appropriate "corresponding adjustment" be made by the other Contracting State in such cases to avoid economic double taxation, taxation of essentially the same profit in the hands of two different legal entities if justified in principle and in amount. In other words, if one country increases the profit attributed to one side of the transaction, the other country should reduce the profit attributed to the other side of the transaction. The competent authorities [13] of the Contracting States are if necessary to consult with each other in determining the adjustment.

B.1.8.4. Other OECD Model Tax Convention articles which apply the arm's length principle include the article concerning dealings between the head office and a permanent establishment (Article 7(2)). Article 7(4) previously explicitly permitted the use of the apportionment of total profit by countries customarily using it, provided the result was consistent with the arm's length principle, but this has been removed from the latest (2010) version of the OECD Model in a major re-write of Article 7.

B.1.8.5. The UN Model contains similar provisions to the OECD Model in Article 9 (at Paragraph 1 especially) and therefore serves as a guide for applying the arm's length principle for developing countries. However the UN Model also includes an additional paragraph (Article 9(3)) which stipulates that a Contracting State is not required to make the corresponding adjustment referred to in Article 9(2) where judicial, administrative or other legal proceedings have resulted in a final ruling that, by the actions giving rise to an adjustment of profits under Article 9(1), one of the enterprises concerned is liable to a penalty with respect to fraud, or to gross or wilful default.

B.1.8.6. There is some ambiguity in the concept of "associated enterprises" in the context of the Model Conventions; e.g. the term is used in the heading of Article 9, but not in the text. The Model Conventions use the concept to cover relationships between enterprises which are sufficiently close to require the application of transfer pricing rules. Concepts such as "management", "capital" and "control" are often defined under the domestic law in many

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

countries and may be extended for transfer pricing. E.g., if parties to the transaction make arrangements differing from those made by unrelated parties this could be considered to lead to a situation of “control”. Also, sometimes a wider definition including both *de jure* (i.e. according to legal form) and *de facto* (i.e. according to practical reality) control, which are difficult to define, may be adopted based on the anti-avoidance provisions in domestic law.

B.1.8.7. The Model Conventions also spell out in Article 25 a key transfer pricing dispute resolution mechanism — the Mutual Agreement Procedure (MAP). The MAP facilitates the settlement of disputes on corresponding adjustments among competent authorities. It should be noted that the MAP procedure does not guarantee relief as it is voluntary; there is however a duty to negotiate in good faith to try to achieve a result consistent with the treaty allocation of taxing rights. Part C.4 discusses the MAP in more detail.

B.1.8.8. Finally, there are a small number of bilateral treaties which allow for arbitration to resolve transfer pricing disputes.[14] Further, the EU Arbitration Convention[15] establishes a procedure to resolve disputes where double taxation occurs between enterprises of different Member States in the EU as a result of an upward adjustment of profits of an enterprise of one Member State.

B.1.8.9. Overall, the Model Conventions are a critical source of acceptance for the arm’s length principle. Given that many countries around the world follow fairly closely one of the Model Conventions, the arm’s length principle has been widely accepted, even though its imperfections are also widely recognized.

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

B.1.8.10. Transfer pricing rules have been developed mainly within the members of the OECD (i.e. developed countries) only because of their historical and economic backgrounds. Many developing countries currently face some of the same conditions as the OECD countries did in the period from the 1970s to the 1990s. It is therefore useful to focus on certain key areas where many developing countries are encountering difficulties with administering the arm’s length principle.

B.1.8.11. Developing countries often have substantial problems with the availability of comparable transactions. This issue is considered more fully in Part B2; 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.

B.1.8.12. Documentation requirements should as far as possible be common between the two Models (UN and OECD), because diversity in documentation rules results in excessive compliance costs for MNEs and smaller enterprises. Targeted documentation requirements can be an alternative to full scale documentation where transactions are simple and the tax at issue is

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

[15] Convention 90/436/EEC 1990.

not large. This may be especially important in responding to the needs and capabilities of small and medium-sized enterprises (SMEs).

B.1.9. Global Transfer Pricing Regimes

B.1.9.1. The UN and OECD Model Conventions, the OECD Guidelines and domestic legislation of various countries have provided examples for introduction of transfer pricing legislation worldwide, in response to the increasing globalization of business and the concern that this may be abused to the detriment of countries without such legislation. Many other countries depend on anti-avoidance rules to deal with the most abusive forms of transfer pricing; see further Part B.8 on the legislative design principles for a transfer pricing regime.

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

B.1.10. Transfer Pricing as a Current and Future Issue

General issues with transfer pricing

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

B.1.10.2. Increasing globalization, sophisticated communication systems and information technology allow an MNE to control the operations of its various subsidiaries from one or two locations worldwide. Trade between associated enterprises often involves intangibles. The nature of the world on which international tax principles are based has changed significantly. All these issues raise challenges in applying the arm's length concept to the globalized and integrated operations of international enterprises. Overall, it is clear that in the 21st century the arm's length principle presents real challenges in allocating the income of highly integrated international enterprises.

B.1.10.3. It is widely accepted that transfer pricing is not an exact science and that the application of transfer pricing methods requires the application of information, skill and judgement by both taxpayers and tax authorities. In view of the skill, information and resource "gaps" in many developing countries, this can be very difficult for those developing countries; the task often requires the best officials, who may leave the tax department after acquiring their special skills. The intention of this Manual is to play a part in reducing those gaps.

Table B. **1.1: Countries with Transfer Pricing Regimes and Emerging Regimes**

Transfer pricing and developing countries

B.1.10.4. For all countries, but particularly for many developing countries, equipping an administration to deal fairly and effectively with transfer pricing issues seems to be a "taxing exercise", both literally and figuratively.

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

Lack of comparables

B.1.10.6. One of the foundations of the arm's length principle is examining the pricing of comparable transactions. Proper comparability is often difficult to achieve in practice, a factor which in the view of many weakens the continued validity of the principle itself. The fact is that the traditional transfer pricing methods (CUP, RPM and CP) directly rely on comparables. These comparables have to be close in order to be of use for the transfer pricing analysis. It is often extremely difficult in practice, especially in some developing countries, to obtain adequate information to apply the arm's length principle for the following reasons:

1. There tend to be fewer organized operators in any given sector in developing countries; so finding proper comparable data can be very difficult;

2. The comparable information in developing countries may be incomplete and in a form which is difficult to analyse, as the resources and processes are not available. In the worst case, information about an independent enterprise may simply not exist. Databases relied on in transfer pricing analysis tend to focus on developed country data that may not be relevant to developing country markets (at least without resource and information-intensive adjustments), and in any event are usually very costly to access; and

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

B.1.10.7. Given these issues, critics of the current transfer pricing methods equate finding a satisfactory comparable to finding a needle in a haystack. Overall, it is quite clear that finding appropriate comparables in developing countries for analysis is quite possibly the biggest practical problem currently faced by enterprises and tax authorities alike, but the aim of this Manual is to assist that process in a practical way. Part B.2 of this Manual provides analysis and practical examples on Comparability Analysis.

Lack of knowledge and requisite skill-sets

B.1.10.8. Transfer pricing methods are complex and time-consuming, often requiring time and attention from some of the most skilled and valuable human resources in both MNEs and tax administrations. Transfer pricing reports often run into hundreds of pages with many legal and accounting experts employed to create them. This kind of complexity and knowledge requirement puts tremendous strain on both the tax authorities and the taxpayers, especially in developing countries where resources tend to be scarce and the appropriate training in such a specialized area is not readily available. Their transfer pricing regulations have, however, helped some developing countries in creating requisite skill sets and building capacity, while also protecting their tax base.

Complexity

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

B.1.10.10. In developing countries resources, monetary and otherwise, may be limited for the taxpayer (especially small and medium sized enterprises (SMEs)) that have to prepare detailed and complex transfer pricing reports and comply with the transfer pricing regulations, and these resources may have to be "bought-in". Similarly the tax authorities of many developing countries do not have sufficient resources to examine the facts and circumstances of each and every case so as to determine the acceptable transfer price, especially in cases where there is a lack of comparables. Transfer pricing audits also tend to be a long, time consuming process which may be contentious and may ultimately result in "estimates" fraught with conflicting interpretations.

B.1.10.11. In case of disputes *between* the revenue authorities of two countries, the currently available prescribed option is the Mutual Agreement Procedure as noted above. This too can possibly lead to a protracted and involved dialogue, often between unequal economic powers, and may cause strains on the resources of the companies in question and the revenue authorities of the developing countries.

Growth of the digital economy

B.1.10.12. The Internet has completely changed the way the world works by changing how information is exchanged and business is transacted. Physical limitations, which have long defined traditional taxation concepts, no longer apply and the application of international tax concepts to the Internet and related e-commerce transactions is sometimes problematic and unclear.

B.1.10.13. From the viewpoint of many countries, it is essential for them to be able to appropriately exercise taxing rights on these intangible-related transactions, such as e-commerce and web-based business models. Whether they can do so effectively using the current international taxation models is a matter of considerable debate. Many have suggested the amendment of key existing concepts, such as permanent establishment, as well as the introduction of new concepts, such as an equalization levy, to include the virtual world and its workings in the ambit of international taxation. In many developing countries, the digital economy currently plays a role as a key growth driver in their economic engine and it is therefore imperative for tax authorities to tackle transfer pricing issues related to it.

Location savings

B.1.10.14. Some countries (usually developing countries) take the view that the economic benefit arising from moving operations to a low-cost jurisdiction, i.e., "location savings", should accrue to that country where such operations are actually carried out.

B.1.10.15. Accordingly the determination of location savings, and their allocation between the group companies (and thus, between the tax authorities of the two countries) has become a key transfer pricing issue in the context of developing countries. Unfortunately, most international guidelines do not provide much guidance on this issue of location savings, though they sometimes do recognize geographic conditions and ownership of intangibles. The US Section 482 regulations provide some sort of limited guidance in the form of recognizing that adjustments for significant differences in cost attributable to a geographic location must be based on the impact such differences would have on the controlled transaction price given the relative competitive positions of buyers and sellers in each market. The OECD Guidelines also consider the issue of location savings, emphasizing that the allocation of the savings depends on what would have been agreed by independent parties in similar circumstances. This issue is dealt with in greater detail later in this Manual. An overview of location savings is provided in Part B.2 and some specific country practices on the use of location savings are provided in Part D.

B.1.11. Summary and Conclusions

B.1.11.1. Transfer pricing is generally considered to be the major international taxation issue faced by MNEs today. Even though responses to it will in some respects vary, transfer pricing is a complex and constantly evolving area and no government or MNE can afford to ignore it.

B.1.11.2. Transfer pricing is a difficult challenge for both governments and taxpayers; it tends to involve significant resources, often including some of the most skilled human resources, and costs of compliance. It is often especially difficult to find comparables, even those where some adjustment is needed to apply the transfer pricing methods.

B.1.11.3. The rise of the digital economy has brought to the fore the transfer pricing aspects of ownership, management, use and transfer of intangibles which can be highly complex due to the fact that intangibles are typically hard to value while being easy to transfer between parties. The plethora of issues involved in the transfer pricing of intangibles may put an additional burden on the constraints faced by taxpayers and tax authorities in developing countries.

B.1.11.4. For governments, transfer pricing administration is resource intensive and developing countries often do not have easy access to resources to effectively administer their transfer pricing regulations. In addition, from the government's perspective, transfer pricing manipulation reduces revenue available for country development, and with increasing globalization the potential loss of revenue may run into billions of dollars.

B.1.11.5. Overall, it is a difficult task to simplify the international taxation system, especially transfer pricing, while keeping it equitable and effective for all parties involved. However, a practical approach, such as that proposed by this Manual, will help ensure the focus is on solutions to these problems. It will help equip developing countries to address transfer pricing issues in a way that is robust and fair to all the stakeholders, while remaining true to the goals of being internationally coherent, seeking to reduce compliance costs and reduce unrelieved double taxation.

B.1.11.6. This chapter aimed to introduce the fundamentals of the concepts involved in transfer pricing such as the arm's length principle and issues related to it. Subsequent chapters will deal with specific transfer pricing concepts in greater detail.

Annex 2

D.2. Brazil Country Practices[16]

D.2.1. Introduction: General Explanation

D.2.1.1. Brazil introduced a law on transfer pricing, through Law n. 9430/1996, in 1996.[17] The bill was proposed to deal with tax evasion trough transfer pricing schemes, and according to the proposal, it adopted the arm´s length principle.

D.2.1.2. The methodology introduced by the law listed the traditional transaction methods (Cost Plus Method and Resale Price Method) but denied the use of transactional profit methods (the Profit Split Method and Transactional Net Margin Method) and formulary apportionment. Regarding the CUP Method, for exports or imports, the law introduced a methodology that is similar to OECD practices; and in addition Brazil also adopted the so called Sixth Method (which is the CUP method applied specifically for commodities). However, with regard to the Cost Plus Method and Resale Price Method, instead of making use of comparable transactions, the law established fixed margins for gross profits and mark-up.

D.2.1.3. In 2012 the law was changed by adopting different margins for certain specific sectors as applicable to the Resale Price Method (RSP). The Brazilian perspective is that the conventional use of the Resale Price Method and the Cost Plus Method implies some uncertainty and juridical instability, since they are implemented by the taxpayer without previous consent or summary review by the tax authorities. This affects stability and expectations in economic and fiscal relations.

D.2.1.4. Brazil's Resale Price Method and Cost Plus Method with fixed margins are applicable to both export and import operations. In order to make them easier to understand they are presented in the following paragraphs disregarding practical distinctions. A more detailed explanation to differentiate the application to imports and to exports and how to deal with that will be discussed separately. This is because the Brazilian transfer pricing law details the application of the two methods (RSP and CPM) for exports and imports in separate sets of rules. There are also specific methods for tradable commodities and interest that are addressed in part 10.2.3 of this Chapter.

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[17] Law n. 9,430/1996 was modified by Law 9.959/2000, Law n. 10,451/2002, Law n. 11,727/2008, Provisional Measure n. 499/2008, converted into Law n. 11,941/2009, Provisional Measure n. 478/2009, Provisional Measure n. 563/2012, converted into Law n. 12,715/2012, Provisional Measure n. 575/2012, converted into Law n. 12,766/2012 (this last one affecting only interests). These laws are consolidated and explained by administrative regulations issued by the Brazilian Federal Revenue Secretariat: Normative Instruction RFB n. 1,312/2012, available at http://normas.receita.fazenda.gov.br/sijut2consulta/link.action?idAto=39257&visao=anotado (text in Portuguese).

D.2.1.5. Brazil's Resale Price Method and Cost Plus Method with fixed margins are not 'safe harbour' methods. For these purposes, safe harbours mean provisions that apply to a defined category of taxpayers or transactions that relieve eligible taxpayers, at their own option, from certain obligations in pricing controlled transactions otherwise applicable under the arm's length standard. The Resale Price Method and Cost Plus Method with fixed margins can be applied by the taxpayers as regular methods, not as safe harbours. The fixed margins are subject to modifications authorized by the Minister of Finance, based on the taxpayer´s request or *ex officio*, as discussed below.

D.2.2 Resale Price Method with Fixed Margins

Explanation of the methodology

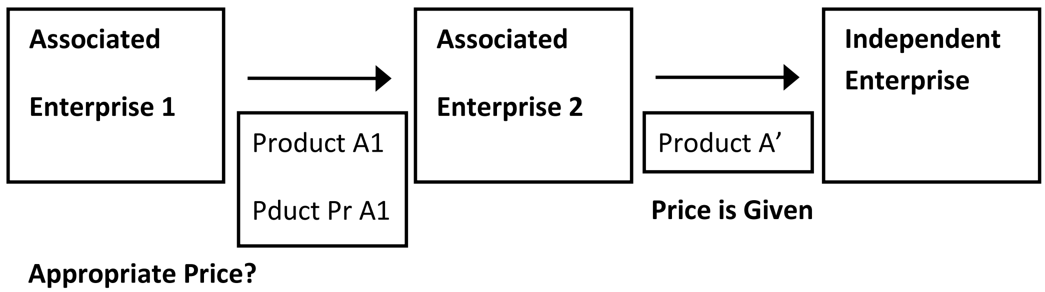
D.2.2.1. The mechanism of the Resale Price Method using fixed gross profit margins is considered by Brazil to be similar to the conventional Resale Price Method with margins, except that the gross margins are set out in the rules, rather than being based on comparables. See Figure 10.1 below. In order to determine the transfer price (deemed arm´s length price, or parameter price, as it is called in Brazilian transfer pricing laws), the resale price that the reselling company (Associated Enterprise 2) charges to an unrelated customer (Independent Enterprise) is reduced by a fixed gross profit margin. The remainder is the acceptable transfer price between the associated parties (Associated Enterprise 1 and Associated Enterprise 2), which is the parameter price.

D.2.2.2. Reference is made below to two applications of how this method could be implemented for transfer pricing of products, including cases where the product is subject to manufacturing activities (value added costs) before it is resold.

D.2.2.3. The method is based on the participation of transferred goods in the product that is resold (which is 100 per cent in a simple resale). Then the parameter price will be the resale price participation less a profit margin, fixed by law. Therefore, this methodology is also feasible to apply when other inputs (bought from independent companies) are combined with the inputs traded between associated enterprises and the final goods, manufactured from these different sources of inputs, are resold by a Brazilian enterprise.

D.2.2.4. *Resale Price* (without manufacturing)
If the product traded between related parties is not subject to any manufacturing modifications the formula adopted will be the same and the participation ratio will be 100 per cent, since the price of product A1 will be equal to the resale cost of product A:

Figure D. 1: Resale Price Method (without manufacturing)



(Net) Resale Price	=	$ 10,000
Participation Ratio (of Prod. A1 in Prod. A')	=	100%
Participation Value (of Prod. A1 in Prod. A')	=	$ 10,000
Resale price margin (20%)	=	€ 2,000
Parameter Price	=	€ 8,000

D.2.2.5. In this case the calculation is simple as the parameter price (deemed arm´s length price) is the resale price of the same product (charged between independent parties) reduced by: unconditional discounts granted; taxes and contributions on sales; commissions and brokerage fees paid; and a fixed profit margin of, for example, 20 per cent (according to current Brazilian law).

TP (parameter price) = NRP – GPM x NRP,
Where:

- TP (parameter price) = transfer price determined by Brazilian law. The maximum price on imports or the minimum price on exports;
- NRP = net resale price;
- GPM = gross profit margin = the value of gross profit margin ratio, as determined by law or tax regulations (20 per cent) in this simplified example); and
- TP (parameter price) = NRP – GPM x NRP = NRP – 20% x NRP = 80% NRP.

Hence:

• (Net) Resale Price	$ 10,000
• – Resale Price Margin (20%)	$ 2,000

- A1 Transfer Price under Brazilian law = $ 8,000

D.2.2.6. *Resale Price* (with manufacturing operation)

In this methodology the transfer price would be calculated having regard to the proportional participation of the goods negotiated between associated parties (product A + input) in the goods resold to an independent enterprise (product B). This methodology reduces the weakness of using the Resale Price Method when the reseller adds substantial costs to the product traded between associated parties. The resale price to be considered shall be that price agreed upon by the reselling company with an independent enterprise. More details are given below.

Resale Price (with manufacturing operation)

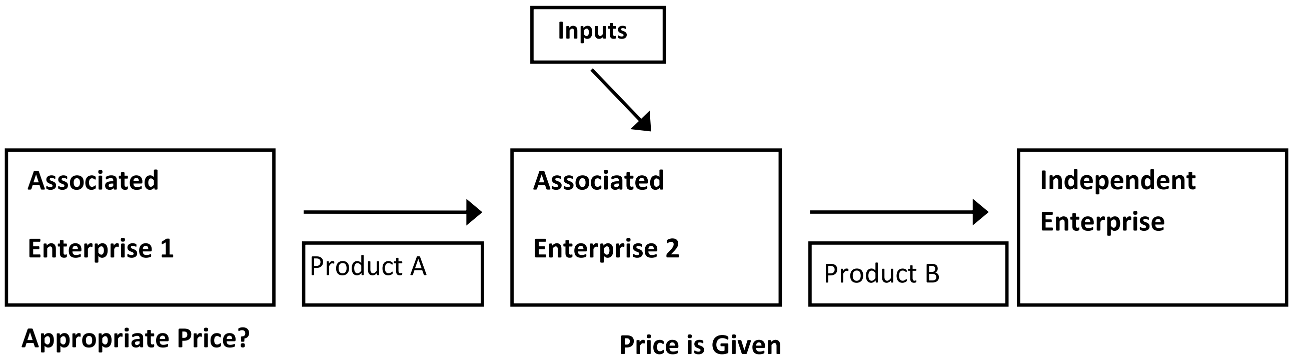
D.2.2.7. In this more elaborate approach the parameter price (deemed to be the arm´s length price) would be the difference between the *participation value* of the sale price of goods (Product A) in the net resale price (Product B) less its "*gross profit margin*" participation. For this purpose, the *participation value* of Product A in the net resale price (Product B) would be: the application of the *participation ratio* of the input (Product A) to the total cost of the Product B multiplied by the *net resale price* (of Product B).[18]

D.2.2.8. The above-mentioned *participation ratio* is determined as follows: the ratio of the price of Product A (input) to the total cost of the goods resold (Product B), calculated according to the company's cost spreadsheet. The *net resale price* is the weighted average price of sales of the goods resold (Product B), less unconditional discounts granted, indirect taxes on sales, and commissions and brokerage fees paid. "Unconditional discounts" are those that do not depend on future events and that are detailed in the invoice.

D.2.2.9. The *gross profit* of Product A (in the resale of Product B) is the application of, for example, a 30 per cent (gross profit margin) on the *participation value* referred to above. As mentioned before, in this approach the gross profit margin will be provided by law. See Figure D.2. The 30 per cent margin may vary depending on the economic sector of the activity performed by Associated Enterprise 2.

[18]It should be noted that the participation ratio has nothing to do with the fixed margin but depends on the cost of imported inputs and the COGS, see D.2.2.8

Figure D. 2: Resale Price Method (with manufacturing)



(Where Product A is an input for Product B)

(Net) Resale Price	=	$ 10,000
Participation Ratio (of Prod. A in Prod. B)	=	60%
Participation Value (of Prod. A in Prod. B)	=	$ 6,000

D.2.2.10. In order to avoid distortions between companies operating within Brazil it is necessary to ensure accounting uniformity between taxpayers in the country. If certain expenses are characterized as operating expenses by some companies and costs of goods sold by others the system will not be satisfactorily implemented.

The general formula for the inter-company transfer price would be (for a 30 per cent margin):
TP (parameter price) = PV – GPMV,

Where:

- TP (parameter price) = deemed arm´s length transfer price determined under Brazilian law. The maximum price on imports or the minimum price on exports.
- PV = participation value of the goods transferred to the associated enterprise in the net resale price = (price of Product A ÷ total cost of Product B) x (net resale price of Product B);
- GPM = gross profit margin = the value of gross profit margin ratio, as determined by law or tax regulations (30% in this example).
- GPMV = GPM x PV = GPM x (price of Product A ÷ total cost of Product B) x (net resale price of Product B) = 30% (price of Product A ÷ total cost of Product B) x (net resale price of Product B).

- TP (parameter price) = PV – GPMV = ((price of Product A ÷ total cost of Product B) x (net resale price Product B)) — 30% x ((price of Product A ÷ total cost of Product B) x (net resale price Product B)) = PV (1 – GPM)

Fixed margins for the Resale Price Method

D.2.2.11. Brazilian transfer pricing legislation establishes different margins for specific economic sectors regarding the RSP Method for imports as follows (including simple resale operations and manufacturing operations):

I — **40 per cent**, for the following sectors:

- Pharmaceutical chemicals and pharmaceuticals;
- Tobacco products;
- Equipment and optical instruments, photographic and cinematographic;
- Machinery, apparatus and equipment for use in dental, medical and hospital;
- Petroleum, and natural gas (mining industry), and
- Petroleum products (derived from oil refineries and the like);

II — **30 per cent** for the following sectors:

- Chemicals (other than pharmaceutical chemicals and pharmaceuticals);
- Glass and glass products;
- Pulp, paper and paper products; and
- Metallurgy; and

III — **20 per cent** for the remaining sectors.

D.2.2.12. In order to apply such margins the law also states that in the event that the company engages in activities described in more than one of the categories mentioned above (I, II and III), the margin that should be adopted to apply the RSP Method is the margin corresponding to the activity sector in which the imported goods are intended to be used. In the event of the same imported goods being sold and applied in the production of one or more products, or if the imported goods are subjected to different manufacturing processes in Brazil, the final price parameter is the weighted average of the values found by applying the RSP Method, according to their respective destinations.

D.2.2.13. For exports the applicable margins in the foreign country are: 15 per cent for wholesale and 30 per cent for retail sales.

D.2.2.14. The Minister of Finance, ex officio (that is, by his or her own volition), or by request, is authorized by law to modify these margins. A request for modification presented by a taxpayer must be fully justified, and supplied with the proper documentation as established in the law.

D.2.2.15. Example 1: Resale of Same Product

A manufacturing enterprise domiciled in Country X, MCO, sells Product A with no similar product available worldwide to an exclusive distributor domiciled in Brazil, YD, for $16,000 per unit. YD, in its turn, resells the same Product A to customers for $18,750. According to the transfer pricing rules of Brazil, the Resale Price Method provides for a 20 per cent gross profit margin ($3,750). Therefore, the arm's length transfer price applicable to the transaction between MCO and YD would be $15,000 on imports of Product A. Thus for YD, the buyer, there will be a transfer pricing adjustment of $1,000 per unit ($16,000 – $15,000).

D.2.2.16. Example 2: Different Products, with manufacturing operation

A controlling enterprise domiciled in Country A, HOLDCO, sells inputs to a subsidiary domiciled in Brazil (a chemical plant other than pharmaceutical) for $400 per unit. In its turn, the subsidiary manufactures final products that are to be sold to local customers at $1,200 per unit (net resale price). Along with the inputs acquired from HOLDCO, the subsidiary also uses other inputs, acquired in the host country, in the industrialization process of the final product. The cost of such additional inputs corresponds to 60 per cent of the total cost of the final product, and so the participation ratio of the input sold by HOLDCO is 40 per cent ($400), thus the total cost is $1000. The Resale Price Method in Country B imposes a fixed margin of 30 per cent in order to calculate the applicable transfer price. Based on the information above, the calculation is as follows:

PV = participation value of the goods transferred to the associated enterprise in the net resale price = (price of Product A ÷ total cost of Product B) x (net resale price of Product B) = $400/$1000 x $1200 = $480;

GPM = 30% in this example

GPMV = GPM x PV = $480 x 30% = $144

D.2.2.17. Example 3: Intercompany Software Licenses

SIRFRO, a service provider domiciled in Country A, in Europe, exports licenses of unique software to its affiliated company established in Brazil, named SARPRO. Each software license agreement grants the affiliated company the right to sublicense it within their respective territory. As a result, SIRFRO charges SARPRO a monthly royalty fee of $140,000, while it makes $160,000 out of sublicense agreements per month. According to the transfer pricing rules of Brazil, the parameter price (deemed to be the arm´s length price) in transactions like the one performed by SIRFRO shall be calculated by decreasing a 20 per cent fixed gross margin of the sublicense price resold. Thus the parameter price would be equal to $160,000 minus $160,000 x 20%, which is $128,000. Thus the transfer pricing adjustment would be $12,000 per month ($140,000 – 128,000) to SARPRO´s tax basis, in Brazil

Important note: This applies only to intangibles that are imported for resale; for other import operations with intangibles see D.2.8.2.

D.2.3. Cost Plus Method With Fixed Margins

D.2.3.1. Explanation of the methodology:

Similar to the Resale Price Method with fixed margins, the Cost Plus Method may be used with a predetermined gross profit mark-up. The basic functionality of this method is similar to the non-predetermined margin (or traditional) Cost Plus Method except that the gross margins are set out in the rules rather than based on comparables. The method focuses on the related product manufacturing or service providing company determining transfer pricing for transactions with associated enterprises. As explained above, the parameter price (deemed to be the arm´s length price) is reached by adding a predetermined cost plus mark-up to the cost of the product or service. This will be a maximum value on imports or a minimum value on exports.

D.2.3.2. Unlike the Resale Price Method, the Cost Plus Method with predetermined fixed gross profit mark-ups does not require the taxpayer to calculate the ratio of certain inputs to the final product. Thus, the gross profit mark-up is applied to the costs as a whole to determine the parameter price. See Figure D.3 below.

The calculation formula is:

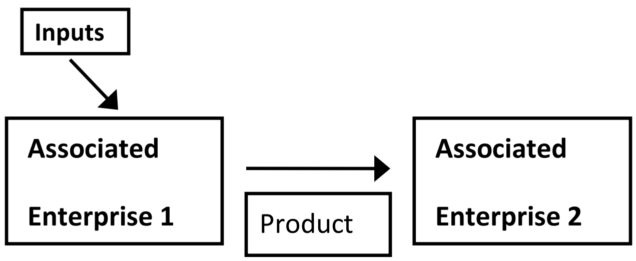
TP (parameter price, which is deemed to be the arm´s length price) = PC + GPM x PC = PC x (1 + GPM)
Where

- TP (parameter price) = transfer price determined by Brazilian law. The maximum price on imports or the minimum price on exports.

- PC = product cost.
- GPM = gross profit mark-up, as determined by law or tax regulations (20 per cent in this simplified example, which is the fixed gross profit mark-up for export operations according to Brazilian law).

This method may be also applied in cases where the product is not subject to substantial modification, that is, where Associated Enterprise 1 merely resells the product to Associated Enterprise 2. This method can also be used for services and intangibles, however the existence of cost sharing agreements in the latter case will it make more complex to apply.

Figure D. 3: Cost Plus Method



Appropriate Price?

Costs for Associated Enterprise 1	=	$ 5,000
+ Gross Profit Mark-up (20%)	=	$ 1,000
Parameter price (arm's length)	=	$ 6,000

Fixed margins for the Cost Plus Method

D.2.3.3. Brazilian transfer pricing law provides two fixed gross profit mark-ups for the Cost Plus Method, depending on whether import or export operations are being addressed. For export operations from Brazil the fixed gross profit mark-up is 15 per cent, and for imports it is 20 per cent (which is the required gross profit mark-up for the export country).

D.2.3.4. The Minister of Finance, ex officio, or by request, is authorized by law to modify these margins. A request presented by a taxpayer must be fully justified, and supplied with the proper documentation as established in the law.

D.2.3.5. Example: Intercompany Distribution

PHARMAX, a pharmaceutical industry with headquarters in Brazil, acquires the active ingredient of a drug produced in its laboratories from an independent enterprise (located in Brazil or abroad). The price paid in the acquisition of the active ingredient is $100 per unit, while PHARMAX exports medicine to companies in the same MNE group for $120 per unit. The Cost Plus Method in Brazil requires the exporter to stipulate prices taking into consideration a 15 per cent gross profit mark up so as to comply with transfer pricing rules. As a result, from Brazil's perspective, PHARMAX should not sell medicine to its affiliates in the other countries for less than $115 per unit ($100 + 15% of $100). Thus there would be no transfer pricing adjustment ($120 > $115).

D.2.3.6. Example: Cost Plus Method as Applied to Imports

PHARMCO is an MNE in the pharmaceutical industry with a distributor in Brazil named BRAZDIST. BRAZDIST imports a medicine produced by PHARMCO in Country B. PHARMCO acquires the active ingredient of this medicine from an independent enterprise, and incurs other operational costs that correspond to an amount (COGS) of $100 per unit. The price paid by BRAZDIST when importing such medicine from PHARMCO is $150 per unit. The Cost Plus Method, in such cases, requires a 20 per cent gross profit mark up so as to comply with transfer pricing rules. As a result, from Brazil's perspective, PHARMCO should not sell medicine to its affiliates in BRAZIL for more than $120 per unit ($100 + 20% of $100). Thus there would be a transfer pricing adjustment of $30 per unit applicable to BRAZDIST.

D.2.4. Differences Between the Application of the Methods Regarding Import and Export Operations

The RSP and CPM methods with fixed margins are applicable both to export and import operations.[19] Considering the RSP with fixed margins, depicted in Figures D.1 and D.2 of this Chapter, it would be applicable in the country of Enterprise 1 for export operations, and in the country of Enterprise 2 for import operations, hence:

- For exports: TP (parameter price) > PV – GPM, which means that (PV – GPM) is the minimum acceptable transfer price for the tax basis calculation.

[19] The Law and administrative regulations (named Normative Instructions) deal separately with import and export operations, considering particular aspects of each type, and also allowing for specific adjustments.

- For imports: TP (parameter price) < PV – GPM, which means that (PV – GPM) is the maximum acceptable transfer price for the tax basis calculation.

Considering the CPM with fixed margins, in Figure D.3 of this Section, it would be applicable in the country of Enterprise 1 for export operations, and in the country of Enterprise 2 for import operations, hence:

- For exports: TP (parameter price) > PC (1 + GPM), which means that PC (1 + GPM) is the minimum acceptable transfer price for tax basis calculation.
- For imports: TP (parameter price) < PC (1 + GPM), which means that PC (1 + GPM) is the maximum acceptable transfer price for tax basis calculation.

However, due to information accessibility the RSP Method is usually more suitable when the Brazilian company imports and the CPM is usually more suitable when the Brazilian company exports, as explained below.

D.2.5. Imports

D.2.5.1. Considering the case where the product resold is subject to value added costs or manufacturing by the reselling associated enterprise, the RSP Method is normally more useful for imports than for exports. The reason for this is that companies may not disclose their production or manufacturing costs, even to other associated companies located in Brazil. This aspect would jeopardize the method's applicability for exports, because the necessary manufacturing cost data incurred by the associated importing enterprise would be unavailable for the associated Brazilian exporting enterprise and the Brazilian tax administration. Even if the enterprises involved have complete access to each other's books there is still the problem of information availability to the Brazilian tax administration. In addition, the TP Regulations allow the use of a comparable by applying necessary adjustments.

D.2.5.2. If the RSP Method is applied for import transfer pricing, the manufacturing importer uses its own accounting book costs to calculate the correct transfer price, with no need to request the cost data incurred by the exporting associated enterprise. Furthermore in the case of imports the tax administration has full access to evaluate the uncontrolled operations (with independent enterprises). As a result the Resale Price Method with fixed margins is recommended for import operations.

D.2.6. Exports

D.2.6.1. For the corresponding reasons mentioned above as regards the Resale Price Method, the CPM is more practical for exports than for imports. Companies may not disclose their production or manufacturing costs, even to other associated companies located in Brazil, which jeopardizes the method applicability for imports, because the necessary manufacturing cost data incurred by the associated exporting enterprise may be unavailable for the associated Brazilian importing enterprise. Even if the enterprises involved have complete access to each other's books there is still a problem of information accessibility to the Brazilian tax administration.

D.2.6.2. If the CPM is applied for determining the export transfer price the Brazilian manufacturing exporter uses its own booked costs to calculate the correct transfer price, with no need to request any data from the non-Brazilian affiliate. Furthermore, in the case of exports, all necessary information can be accessed and verified by the Brazilian tax administration. As a result the Cost Plus Method with fixed margins is typically applied for Brazilian export operations.

D.2.7. Strengths and Weakness of the Brazilian Methods with Predetermined Profit Margins

D.2.7.1. The strengths of Brazil's predetermined profit margins when using the Resale Price Method and Cost Plus Method, which focus on simplicity**,** include:

- It avoids the need for specific comparables;
- The use of the conventional Resale Price Method and Cost Plus Method depends on the availability of certain data, databases or reports to empirically determine the gross profit margin and gross profit mark-up. In general these elements are not easy to find;
- It frees scarce human resources and can be applied without technical knowledge of specific transfer pricing issues;
- It stabilizes the expectations of taxpayers with respect to their Brazilian tax liability associated with inter-company transactions;
- It is a low-cost system for companies and the tax administration in that it does away with one aspect of a transfer pricing analysis, the need to empirically determine gross margins;
- It has a strong emphasis on practicality;
- It does not distort competition among enterprises located where the methodology is applied, since they are subject to the same tax burden, and they are not benefitting from asymmetry of information;
- It allows for simple implementation by tax authorities when auditing taxpayers; and
- It is simple for taxpayers to apply.

D.2.7.2. The weaknesses of Brazil's predetermined profit margins when using the Resale Price Method and Cost Plus Method include:

- The approach may lead to double taxation if there is no access to competent authorities to negotiate relief from double taxation;
- The method requires clear classifications and accounting conformity with respect to the allocation of expenses between COGS and operating expenses;
- It is unavoidable that some Brazilian enterprises will be taxed at (higher or lower) profit margins not compatible with their profitability. This is because the fixed margin method applies regardless of the cost structures of taxpayers. For example, otherwise economically identical taxpayers with large COGS relative to operating

costs will face higher tax burdens than taxpayers with low COGS relative to operating costs.

D.2.8. Other Explanations of the Brazilian Transfer Pricing Methodology

D.2.8.1. The law and regulations set a precise number of methods for import and export transactions that are, in fact, specific methodologies for CUP, CPM and RSP, as follows:

For import transactions:

Comparable Uncontrolled Price Method (PIC and PCI used for transactions in commodities) (equivalent to CUP Method)

Resale Price Method (generally 20% gross profit margin (PRL) (equivalent to RSP Method) + other margins for specific sectors (see above section |D. 10.2.2.11)

Cost Plus Method (20% mark-up margin) (CPL) (equivalent to Cost Plus Method)

For export transactions:

Comparable Uncontrolled Price Method (PVEx and PECEX used for transactions in commodities) (equivalent to CUP Methods)

Wholesale Price in the Country of Destination Less Profit Method (15% margin) (PVA) (equivalent to RSP Method)

Retail Price in the Country of Destination Less Profit Method (30% margin) (PVV) (equivalent to RSP method)

Cost Plus Method (15% profit margin) (CAP) (equivalent to Cost Plus Method)

D.2.8.2. In the case of the import or export of commodities subject to trading in internationally recognized mercantile and futures exchanges the method that should be used for imports is the Imports with Price under Quotation (PCI) Method, which is a simplified version of the Comparable Uncontrolled Price Method for imports, as defined in the law, and for exports is the Export with Price under Quotation (PECEX) Method, which is a simplified version of the Comparable Uncontrolled Price Method for exports, as defined in the law.

This mandatory methodology for such products considers the average quotation price on the global market as the arm´s length price. The law has established that the price to be considered is the average daily price of goods or rights subject to public prices in commodities futures on internationally recognized exchange markets (quoted price). However, the law allows for adjustment of the price for the market premium at the date of the transaction, and other adjustments such as quality of goods traded and terms of payment. If there is no transaction in the organized market on a specific date the price to be taken into consideration is the last price information available in the market. If no price is available at all the taxpayer and tax authority may consider an internationally recognized database as a means of establishing a price. This approach for commodities is in line with the updated version of the OECD Guidelines after BEPS.[20]

D.2.8.3. Brazilian transfer pricing legislation does not apply to payments of royalties and technical, scientific, administrative assistance or similar activities (on imports), which remain subject to the conditions for deductibility set out in the tax legislation. In this regard the transfer pricing legislation applies, in general, only on export operations, and, in limited way, on intangibles that are imported for resale (see above Example D.2.2.17.)

D.2.8.4. Under Brazilian transfer pricing legislation there are special rules for interest (paid or credited), which are similar to the fixed margin approach if one considers the issue of predictability and clarity. Current legislation states that in the case of a controlled loan transaction (between related parties), or similar transaction, the interest rate to be applied to the transaction is:

i) in the case of transactions in US Dollars with a prefixed rate: market rate of the sovereign bonds of the Federal Republic of Brazil issued in the foreign market in US Dollars;

ii) in the case of transactions in Reais with a prefixed rate: market rate of the sovereign bonds of the Federal Republic of Brazil issued in the foreign market in Reais; and

iii) in all other cases, the LIBOR rate for 6-month deposits;

plus a spread as determined by a tax administrative rule issued by the Minister of Finance. If the actual interest rate of the transaction is different, it is subject to adjustment accordingly. With respect to interest expenses, the spread to be added to the interest rates as mentioned above is 3.5%; with respect to interest credited (received from abroad), the spread to be added to the interest rates as mentioned above is 2.5%.

The interest rate calculated in accordance with these rules is deemed to be the arm´s length rate. The rules also apply to transactions between a resident company and a resident in a non-

[20] The BEPS Report on Actions 8-10 added paragraphs to Chapter II of the Transfer Pricing Guidelines, immediately following paragraph 2.16 on this issue. For additional details see Marcos Aurelio Pereira Valadao, “Transfer Pricing in Brazil and Actions 8, 9, 10 and 13 of the OECD Base Erosion and Profit Shifting Initiative”. *Bulletin for International Taxation*, 296-308, May 2016.

cooperative/low-tax jurisdiction as defined by the law, regardless of whether the resident abroad is a related party.

D.2.8.5. The Brazilian transfer pricing regulations establish that if the taxpayer finds a deviation of 5 per cent, or less, between the actual transfer price and parameter price calculated in accordance with the Brazilian transfer pricing legislation, the taxpayer is not requested to make any adjustment. Thus, in practice there is a range for each price. This allowance rate is only 3 per cent when the method is the CUP for commodities (the so-called 6th method, which corresponds to PCI, for imports, and PECEX, for imports, in Brazilian nomenclature).

D.2.8.6. Brazilian transfer pricing legislation also establishes a broad definition of related parties, which is intended to counter tax planning schemes (as a specific anti-avoidance rule), and this also affects transactions between individuals and companies and some specific transactions (back to back transactions, interposed persons). The transfer pricing legislation also applies to all transactions with Brazilian residents and residents in low tax jurisdictions, as defined in the law, regardless of whether the persons and companies performing the transaction are related. Brazil adopts a list of jurisdictions as prescribed by law and detailed through administrative regulations that encompass low tax jurisdictions, non-cooperative jurisdictions and also privileged tax regimes.

D.2.9. Comments for Countries Considering the Adoption of Fixed Margins

D.2.9.1. Countries may establish different profit margins per economic sector, line of business or even more specifically according to the kind of goods or services dealt with, to calculate the parameter price (deemed arm's length price). The more accurately these are computed and the more margins are established, the more likely it is that the use of the margins will neither distort the system nor the decisions of the players involved.

D.2.9.2. It may not be possible to justify establishing many different margins, depending on the actual amount and types of goods and services exported and imported by a country. This is because it is possible that the country does not export or import a sufficiently large amount or many types of those goods and services and the determination of such margins, or even their applicability, could lead to some difficulties.

D.2.9.3. If a country opts for the application of different margins these may be established at different levels of specificity. In other words such margins could be determined by economic sector (e.g. the primary sector, i.e. the extraction or production of raw materials; secondary sectors such as manufacturing; and tertiary sectors such as services). A country may differentiate further, so that the margins could be determined by line of business at different levels of specificity according to the necessity and ability of a country to determine them. For example, the country could use a margin for the chemical industry as a whole, or different margins for different types of products of the chemical industry (agrochemical, petrochemical, explosives, cosmetics etc). The possibilities are nearly limitless. The differentiation per industry into types of products is adopted by Brazil, where, for the Resale Price Method for imports, the margin for the chemicals sector in general is 30 per cent, while the margin for pharmaceutical chemicals and pharmaceuticals is 40 per cent. See Paragraph D.2.1.3 above.

D.2.9.4. Each country should determine, according to its specific circumstances, the amounts involved and types of goods and services, how specific the margins should be and whether more margins are merited. Also a country may combine different levels of margin specifications if it seems appropriate; it may set forth some general margins for a line of business in addition to more specific margins for some goods.

D.2.9.5. In order to determine such fixed margins the tax authorities will need to do pricing research or purchase such information from existing (public) databases, in order to find appropriate prices that could be used as a comparable. Then, if it seems necessary to specify more profit margins, the tax authorities will need to determine a range of profit margins, that is, a maximum and a minimum profit margin that statistically corresponds to relevant data from uncontrolled transactions. The maximum and minimum profit margins simply represent an acceptable margin of divergence.

D.2.9.6. It is recommended that relevant taxpayers or groups that represent them verify the research, and that the margin found for each sector, line of business, product or service could be applicable to any or the vast majority of transactions in that situation. In short, this method suggests that a margin that is used for a sector, line of business or specific goods and services can be used for similar situations in the same business sector.

D.2.9.7. It is important to emphasize that what will be applied, in practical terms, are not "margins" but "ranges". As a result, what will be identified for a specific sector is an average. Thus, some companies may understand that they will fall below the average number, while others will fall above that number. For example, it is assumed that based on market research in a specific country the average market gross profit for resale transactions in the pharmaceutical sector is 30 per cent. It may well be established that some companies have a 25 per cent margin and others a 38 per cent margin. Thus it would be advisable to have a range — in this case say 28 to 35 per cent — that is regarded as acceptable. The exact calculation of the range will depend on the distribution of the margins; in any case, the fixed margin should be inside the range. The details depend on the market, and if the range is very wide that in itself indicates the need for further specification to a line of products, or even to a specific product.

Annex 3

D.4. Transfer Pricing Practices and Challenges in India

D.4.1. Introduction

D.4.1.1. Transfer pricing provisions were introduced in the Indian Income-tax Act in 2001. The provisions were broadly aligned with the OECD guidelines on transfer pricing. Over the last 15 years, transfer pricing audits in India have thrown up a number of issues and challenges. Administration of the transfer pricing law has also resulted in a number of disputes and protracted litigation. With a view to reducing transfer pricing disputes, a number of initiatives have been introduced by the tax administration in the recent past. Some of the initiatives have included the introduction of an Advance Pricing Agreement (APA) Scheme, inclusion of Safe Harbour provisions, utilisation of the MAP provision in bilateral tax treaties to resolve TP disputes, migration from a quantum of transaction based selection to risk-based selection of TP cases for audit, and issuance of various Circulars and Instructions on transfer pricing matters to provide clarity on TP issues, etc.

D.4.1.2. Due to these initiatives, there has been an impact on the number of cases under audit as well as the number of disputes arising from such audits which have both shown a downward trend. Transfer pricing tax administration can now focus on high risk cases and at the same time provide a reasonable degree of certainty to low risk taxpayers. The new approach is expected to raise the quality of transfer pricing audits without creating an environment of tax uncertainty and protracted litigation.

D.4.1.3. India, as a member of the G-20, has participated in the Base Erosion and Profit Shifting (BEPS) Project on an equal footing with the OECD and other non-OECD member countries and is a party to the consensus developed under the various Action Points of the BEPS Project. The final reports of all the 15 Action Points of the BEPS Project have been endorsed at the highest political level by all G-20 countries, including India. Accordingly, India is committed to implementing all the recommendations contained in the BEPS reports including those on transfer pricing.

D.4.1.4. In subsequent paragraphs of this sub-chapter, various aspects pertaining to the transfer pricing regime in India and the outstanding issues that continue to pose challenges to the transfer pricing administration are discussed.

D.4.2. Transfer Pricing Regulations in India

D.4.2.1. The Indian Transfer Pricing Regulations are based on the arm's length principle. The regulations came into effect from 1 April 2001. The regulations provide that any income arising from an international transaction between associated enterprises shall be computed having regard to the arm's length price (ALP). The concept of associated enterprises has been defined in detail in the regulations.

D.4.2.2. The ALP is to be determined by any of the prescribed methods. The methods prescribed for the determination of an arm's length price are: Comparable Uncontrolled Price Method, Resale Price Method, Cost Plus Method, Transactional Net Margin Method, Profit Split Method and a residual method known as "any other method" to determine the arm's length price under the statute. The regulations do not provide any hierarchy of the methods and support the concept of the "most appropriate method" which provides the most reliable measure of an arm's length result under a particular set of facts and circumstances.

D.4.2.3. The regulations prescribe mandatory annual filing requirements as well as maintenance of contemporaneous documentation by taxpayers if international transactions between associated enterprises cross a threshold, and they contain penalty implications in case of non-compliance. The primary onus of proving the arm's length price of a transaction lies with the taxpayer. In most cases, the Indian entity is taken as the tested party and Indian comparables are used. If the foreign associated enterprise is the lesser complex entity it is taken as the tested party.

D.4.2.4. In order to provide uniformity in the application of transfer pricing law, there are specialised Commissionerates under the supervision of a Principal Chief Commissioner of Income-tax (International Taxation) at Delhi and two Chief Commissioners of Income-tax (International Taxation) stationed at Mumbai and Bengaluru. Transfer Pricing Officers (TPO) are vested with powers of inspection, discovery, enforcing attendance, examining a person under oath, on-the-spot enquiry/verification and compelling the production of books of account and other relevant documents during the course of a transfer pricing audit. The mechanism of the dispute resolution panel (DRP) is also available to taxpayers to resolve disputes relating to transfer pricing.

D.4.2.5. The government of India has a dedicated website which contains comprehensive information about the latest provisions of tax law and related rules, Circulars and Instructions including on transfer pricing. The website has a user friendly interface. It can be accessed at http://www.incometaxindia.gov.in

D.4.3. Transfer Pricing Issues in India

D.4.3.1 . **Comparability Analysis**

Comparability analysis is the key to determining the arm’s length price of an international transaction. However, increased market volatility and increased complexity in international transactions have thrown open serious challenges to comparability analysis and determination of the arm’s length price. Some of these challenges and the responses of the Indian transfer pricing administration in dealing with these challenges are analysed below.

D.4.3.2. **Use of contemporaneous data**: Use of contemporaneous data of comparable companies provides a more accurate arm’s length price in a particular year. Accordingly, the Indian transfer pricing rules gave primacy to the data of the current year, i.e., the year under audit.

D.4.3.3. **Application of data rules:** As stated above, the Indian transfer pricing regulations stipulated that data to be used in analysing the comparability of the uncontrolled transaction with an international transaction should be the data relating to the financial year in which the international transactions have been entered into. However, the rule also provided an exception and permitted the use of data for the preceding two years if it was proved that such data could have an influence on the determination of the arm's length price. This exception resulted in numerous disputes and protracted litigation between taxpayers and the tax authorities. To put an end to such disputes and to provide the taxpayers a degree of flexibility to defend their transfer prices, the Indian Government decided to permit the use of multiple-year data. Thus, for transactions undertaken on or after 1st April 2014 (i.e., from Assessment Year 2015-16), multiple year data of the comparables can be used for the purpose of benchmarking international transactions with associated enterprises.

D.4.4. Issues relating to Risks

D.4.4.1. A comparison of functions performed, assets employed and risks assumed is the basis of any comparability analysis. Indian practice has been to evaluate risk in conjunction with functions and assets. India believes that it is unfair to give undue importance to risks in determination of the arm's length price in comparison to functions performed and assets employed.

D.4.4.2. Identification of risks and of the party which bears such risks are important steps in comparability analysis. India believes that the conduct of the parties is key to determining whether the actual allocation of risks conforms to contractual risk allocation. Allocation of risks depends upon the ability of parties to the transaction to exercise control over such risks. Core functions, key responsibilities, key decision-making and levels of individual responsibility for the key decisions are important factors to identify the party which has control over the risks. Besides, financial capability to bear the risk is also important in establishing whether a party actually bears or controls the risk.

D.4.4.3. In India, MNEs make claims before the transfer pricing officers that related parties engaging in contract R&D or other contract services in India are risk-free entities. Accordingly, these related parties are said to be entitled to only routine (low) cost plus remuneration. MNEs also contend that the risks of R&D activities or services are being controlled by them and Indian entities being risk-free entities are only entitled to low cost plus remuneration.

D.4.4.4. The notion that risks can be controlled remotely by the parent company and that the Indian subsidiary engaging in core functions, such as carrying out research and development (R&D) activities or providing services, is a risk free entity has not been found acceptable. India believes that in many cases the core function of performing R&D activities or providing services is located in India, which in turn requires important strategic decisions to be taken by the management and employees of the Indian subsidiaries. These strategic decisions could be in terms of designing the product or the software; the direction of R&D activities or providing services; and the monitoring of R&D activities. Accordingly, the Indian subsidiary exercises control over the operational and other risks. In these circumstances, the ability of the parent company to exercise control over the risks remotely from a place where core functions of R&D and services are not located is very limited.

D.4.5. Arm's Length Range

4.5.1. In order to align the Indian transfer pricing law to the best international practices, the law was amended recently to introduce a 'Range' concept for determining the ALP, which is applicable for international transactions undertaken on or after the 1st April 2014 (i.e., effective from assessment year 2015-16). The salient features of the 'Range' concept are as follows:

- A dataset of the results/profit margins of six or more comparable companies are to arranged in an ascending order and an arm's length range beginning with the thirty-fifth percentile of the dataset and ending with the sixty-fifth percentile of the dataset (the "Middle 30" of the dataset) is to be constructed;
- If the price at which the international transaction has actually been undertaken is within the range referred to above, then the price of the transaction shall be deemed to be the arm's length price;
- If the price at which the international transaction has actually been undertaken is outside the range referred to above, then the arm's length price shall be the median of all the values included in the dataset (i.e. the 50th percentile);
- However, if the range is not used due to the non-availability of at least six comparable companies, the arithmetic mean shall continue to be used to determine the ALP.

D.4.6. Comparability Adjustment

As with many other countries, the Indian transfer pricing regulations require “reasonably accurate comparability adjustments”. The onus to prove a “reasonably accurate comparability adjustment” is on the taxpayer. The experience of the Indian transfer pricing administration indicates that it is possible to provide capacity utilisation and working capital adjustments. However, the Indian transfer pricing administration finds it difficult to make risk adjustments in the absence of any reliable, robust and internationally agreed methodology to provide risk adjustment.

D.4.7. Location Savings

D.4.7.1. The concept of “location savings”, i.e. cost savings in a low-cost jurisdiction such as India, is one of the aspects taken into account while carrying out comparability analysis during transfer pricing audits. The expression “location savings” has a much broader meaning; it goes beyond the issue of relocating a business from a “high-cost” to a “low-cost” location and relates to any cost advantage that a jurisdiction can provide. MNEs continuously search for options to lower their costs in order to increase their profits. In this respect, India provides various operational advantages to the MNEs, such as availability of low-cost labour or skilled employees, lower raw material cost, lower transaction cost, reasonably priced rental space, lower training costs, availability of infrastructure at a lower cost, various direct and indirect tax incentives, etc.

D.4.7.2. In addition to the above cost advantages, India provides the following Location-Specific Advantages (LSAs) to MNEs:

- Highly skilled, specialised and knowledgeable workforce;
- Access and proximity to large and growing local/regional markets;
- Large customer base with increased spending capacity;
- Superior information networks;
- Superior distribution networks;
- Various policy incentives; and
- Market premium.

D.4.7.3. The incremental profit from LSAs is known as “location rents”. The main issue in transfer pricing is the quantification and allocation of location savings and location rents among the associated enterprises. Using an arm's length pricing approach, the allocation of location savings and rents between associated enterprises should be made by reference to what independent parties would have agreed in comparable circumstances. It is possible to use the Profit Split Method to determine arm's length allocation of location savings and rents in cases where comparable uncontrolled transactions are not available. In these circumstances, it is considered that the functional analysis of the parties to the transaction (functions performed, assets owned and risks assumed), and the bargaining power of the parties (which at arm's length would be determined by the competitiveness of the market, availability of substitutes, cost structure, etc) should both be considered as appropriate factors.

D.4.7.4. However, in situations where comparable uncontrolled transactions are available, the comparability analysis and benchmarking by using the results/profit margins of such local comparable companies will determine the arm's length price of a transaction with a related party in a low-cost jurisdiction. If good local comparables are available, the benefits of location savings can be said to have been captured in the ALP so determined. However, if good local comparables are not available that could capture the benefits of location savings or where the overseas associated enterprise (AE) is chosen as the tested party, the issue of capturing the benefits of location savings would remain an issue in determining the ALP.

D.4.8. Intangibles

General

D.4.8.1. Transfer pricing of intangibles has been a difficult area of work for tax administrations across the world. The situation has been same for the Indian tax administration. The pace of growth of the intangible economy has opened up new challenges to the arm's length principle.

D.4.8.2. Transactions involving intangible assets are difficult to evaluate for the following reasons:

- Intangibles are rarely traded in the external market and it is very difficult to find comparables in the public domain;
- Intangibles are often transferred bundled along with tangible assets; and
- They may be difficult to detect.

D.4.8.3. A number of complications arise while dealing with intangibles. Some of the key issues revolve around determination of the arm's length rate of royalties, allocation of the cost of development of the market and brand in a new country, remuneration for development of marketing and R&D intangibles, their use, transfer pricing of co-branding, etc. Some of the Indian experiences in this regard are discussed below.

D.4.8.4. With regard to payment of royalties, MNEs often enter into agreements allowing use of brands, trademarks, know-how, design, technology, etc. by their subsidiaries or related parties in India. Such payments can be made as a lump sum or by way of periodic payments or a combination of both types of payment. Intellectual property, which is owned by one entity and used by another entity, generally requires a royalty payment as consideration for the use. However, the important issue in this regard has been the determination of the arm's length rate of royalty. The main challenge in determining the arm's length royalty rate is to find comparables in the public domain with sufficient information for comparability analysis. Further, it is difficult to find comparable arm's length prices in most cases. The use of the Profit Split Method as an alternative is generally not a feasible option due to the lack of requisite information.

D.4.8.5. Serious difficulties have been encountered in determining the rate of royalty charged for the use of brands and trademarks in certain cases. In some cases, the user had borne significant costs in promoting the brand/trademark, and to promote and develop customer loyalty for the brand/trademark in a new market. In these cases, the royalty rate charged by the MNE should depend upon the cost borne by the subsidiary or related party to promote the brand and trademark and to develop customer loyalty for that brand and product. In many cases, no royalty is charged from the local subsidiary in an uncontrolled environment and the subsidiary would require an arm's length compensation for economic ownership of the brand and trademark developed by it and for enhancing the value of the brand and trademark (legally owned by the parent companies) in an emerging market such as India.

D.4.8.6. In many cases, Indian subsidiaries using the technical know-how of their parent company have incurred significant expenditure to customise such know-how and to enhance its value by their R&D efforts. Costs of activities, such as R&D activities which have contributed to enhancing the value of the know-how owned by the parent company, are generally considered by the Indian transfer pricing administration while determining the arm's length price of royalties for the use of technical know-how.

D.4.8.7. . Significant transfer pricing issues have also arisen in cases of co-branding of a new foreign brand owned by the parent MNE (a brand which is unknown to a new market such as India) with a popular Indian brand name. Since the Indian subsidiary has developed valuable Indian brands in the domestic market over a period of time, incurring very large expenditure on advertisement, marketing and sales promotion, it should be entitled to an arm's length remuneration for contributing to increasing the value of the little known foreign brand by co-branding it with a popular Indian brand and therefore increasing market recognition.

D.4.9. Intangibles generated through R&D activities

D.4.9.1. Several global MNEs have established subsidiaries in India for research and development activities on a contract basis to take advantage of the large pool of skilled manpower which is available at a lower cost. These Indian subsidiaries are generally compensated on the basis of routine and low cost plus mark-ups. The parent MNEs of these R&D centres justify low cost plus mark-ups on the ground that they control all the risks and their subsidiaries or related parties are risk free or limited risk bearing entities. The claim of the parent MNEs that they control the risk and are entitled to a major part of the profits from R&D activities is typically based on the contention that they:

- Design and monitor all the research programmes of the subsidiary;
- Provide the funds needed for the R&D activities;
- Control the annual budget of the subsidiary for R&D activities;
- Control and take all the strategic decisions regarding the core functions of R&D activities of the subsidiary; and
- Bear the risk of unsuccessful R&D activities.

D.4.9.2. In transfer pricing audits of certain contract R&D centres, the following facts have emerged:

- Most parent companies of MNEs were not able to file relevant documents to justify their claim of controlling the risk of core functions of R&D activities and assets (including intangible assets), which are located in the country of their subsidiary;
- Contrary to the claims made by the parent companies, it was found that day-to-day strategic decisions and monitoring of R&D activities were carried out by personnel of the subsidiary who were engaged in actual R&D activities and bore relevant operational risks;
- The management of the Indian subsidiary also took decisions concerning the allocation of budget to different streams of R&D activities and Indian management also monitored the day-to-day performance of R&D activities; and
- While it was true that funds for R&D activities were provided by the MNE parents that bore the financial risk of the R&D activities, the other important aspects of R&D activities, such as technically skilled manpower, know-how for R&D activities, etc. were developed and owned by the Indian subsidiaries. Accordingly, control over risks of R&D activities lay both with the MNE parent and the Indian subsidiary but the Indian subsidiary controlled more risks as compared to its MNE parent.

D.4.9.3. Thus, it has been inferred that the Indian subsidiaries were not risk-free entities but bore economically significant risks. Accordingly, Indian subsidiaries were entitled to an appropriate return for their functions, including strategic decision-making, monitoring R&D activities, use of their tangible and intangible assets and exercising control over the risks. In view of these facts, a routine and low cost plus compensation model would not arrive at an arm's length price.

D.4.10. Marketing intangibles

D.4.10.1. Transfer pricing aspects of marketing intangibles have been a focus area for the Indian transfer pricing administration. The issue is particularly relevant to India due to its unique market specific characteristics such as location advantages, market accessibility, large customer base, market premium, spending power of Indian customers, etc. The Indian market has witnessed substantial marketing activities by the subsidiaries/related parties of MNE groups in the recent past, which have resulted in creation of local marketing intangibles.

D.4.10.2. The functions carried out by Indian subsidiaries of an MNE Group relating to marketing, market research and market development, including adding value to intangibles such as brands, trademarks and trade names owned by parent companies, as well as creation and development of marketing intangibles like customer lists and dealer networks, have been the subject matter of transfer pricing adjustments in India. The expenditure incurred on these marketing functions has been considered for adjustment by Indian tax authorities on the premise that the Indian taxpayers were incurring these expenses for and on behalf of their parent companies outside India, and that:

- these expenses promoted the brands / trademarks that are legally owned by foreign parent AEs.
- these expenditures created or developed marketing intangibles in the form of brands / trademarks, customer lists, dealer/distribution channels, etc. even though the Indian company may have had no ownership rights in these intangibles.

Based on this premise, it has been held by the Indian tax authorities that the functions carried out, which are in the nature of development of the relevant intangibles, deserve compensation.

D.4.10.3. For computing the value of compensation and the required adjustment, a comparison with the average of AMP (Advertisement, Marketing and Promotion) spends by comparables in a broadly similar line of business has been made to determine the routine spend on AMP for product sale. The expenditure over and above this has been held to be purely for developing the brand value or other marketing intangibles for the benefit of the AE and as a service to the AE, and considered for adjustment along with a mark-up of the service charge on the same, worked out on a cost-plus basis. The understanding going into this approach has been that functions relating to development, enhancement and exploitation of marketing intangibles, now termed as DEMPE (Development, Enhancement, Maintenance, Protection and Exploitation) functions under the BEPS final report on Action Point 8, result in the following two-fold benefit to the AEs:-

(a) Direct Benefit: by way of increased revenue from the territory on account of Sale/Royalty/Fee for Technical Services etc. In many of the cases, such functions may have an impact on revenue enhancement of the associated enterprises in other parts of the world. For example sponsorship of events or sports watched in many countries, launching of brands developed in India in other parts of the world etc.

(b) Indirect Benefit:

(i) Development of Market: the AEs, who are owners of intangibles, obtain an advantage in terms of development of market for themselves. While this kind of advantage builds over a period of time, it is manifested in different ways, e.g. when the AE enters into an agreement with a third party for directly selling goods in India. It is observed in many cases that agreements are concluded in India by the foreign AEs with retail chain companies or e-sellers or large corporate houses, etc. Here, the awareness about the trade intangibles owned by the AE, which were not well-known in the Indian market, is enhanced by the marketing efforts made by the Indian taxpayer, thus adding value to the same. This practice of the Indian subsidiary also creates a platform for the AE when it launches new products in India. Although some of the Indian taxpayers are being compensated partly and some of them not, invariably no separate accounts are maintained by the taxpayer to show which part of the expenditure pertains to the DEMPE functions related to the intangibles and consequent benefits provided to the associated enterprise and which is incurred for routine promotion of the product. The pattern of compensation, if any, by the AEs for such functions is varied. While some of them provide a subsidy to the Indian subsidiary to maintain an agreed profit level, others grant a lump sum compensation which is generally not correlated by the taxpayer to functions discharged by it.

(ii) Enhancement of Exit Value: The marketing activity of the taxpayer bestows another kind of advantage to the AE which is realised when there is a change in ownership of the business – either by way of restructuring within the group or by way of divesting either a part or full business to a third party. At this stage, the exercise of market development, brand development or other value additions to the intangibles like copyrights, patents, trademarks, licences, franchises, customer list, marketing channel, brand, commercial secret etc. are of tremendous importance while negotiating the price of divestment and valuation of assets.

D.4.10.4. The adjustments made by the transfer pricing officers (TPOs) have been subject to judicial reviews in India and although the matter is still to be finally adjudicated by the Supreme Court, the following principles have emerged from the decisions of the High Courts and Tribunals:

(i) The existence of an international transaction in relation to any service or benefit will have to be established before transfer pricing provisions can be applied to place a value on the service or benefit for the purpose of determining compensation.

(ii) The mere fact of unusual or excessive AMP expenditure cannot establish the existence of such a transaction. However, once such a transaction is established, it is possible to benchmark it separately and it need not always be aggregated with other international transactions.

D.4.10.5. The present approach of the Indian tax administration for carrying out transfer pricing adjustments in accordance with the above judicial principles is as below:

- Requesting the taxpayers to produce documents and evidence in a uniform manner including information of previous years
- Carrying out a detailed FAR analysis to identify all the functions of the taxpayer and the AEs pertaining to all international transactions e.g. purchase of raw material/components, payment of royalty, purchase of finished goods, export of finished goods, support services, and direct sales by the AE in India etc.
- Examining whether the marketing activities, marketing research, market development, distribution channel, dealers channel, customer list etc. (DEMPE functions) reflected by the expenditure incurred by the taxpayer and the AE in India are in conformity with the functional and risk profiles and the benefits derived by the taxpayer and the AE, and whether the AE, assuming a risk in the Indian market or benefitting from India in one

way or the other, is dependent upon the DEMPE functions carried out by the Indian subsidiary.

- Finding the most appropriate method to determine the arm's length compensation for the functions performed, assets used, and risks assumed by the Indian entity. The most appropriate method would depend on the facts of the case and could be the CUP method if suitable comparable uncontrolled transactions are found or could be the TNNM or PSM in appropriate cases.

D.4.10.6. The BEPS Report on transfer pricing issues illustrates through examples, the situations in which a marketeer/distributor can expect compensation for the AMP functions carried out by it. The common threads arising from these examples are:

- Compensation for the AMP function will depend on the intensity with which the function is performed, the extent of assets employed and the amount of risk borne by the parties in respect of the AMP function. Compensation need not be separate. It can be part of the price of another transaction. Where the AMP function is performed with the intention by the taxpayer to exploit the results itself, no separate compensation is receivable for the function.

The person who takes the important decisions relating to the AMP function such as deciding the strategy, fixing the budget and exercising overall control over the function is the person who bears the risk relating to the AMP activity and he is entitled to all the excess profits generated on account of the function.

D.4.10.7. The Indian tax administration has been applying these principles to make adjustments but it is apparent that the process is complex, fact intensive and not free from disputes. The efforts being made by the Indian tax authorities to bring uniformity in approach and the expected judicial verdict from the Indian Supreme Court are likely to bring more clarity in the process.

D.4.11. Intra-group Services

D.4.11.1. Globalisation and the drive to achieve efficiencies within MNE groups have encouraged sharing of resources to provide support to group entities in one or more locations by way of shared services. Some of the services are relatively straightforward in nature, such as marketing, advertisement, trading, management consulting, etc. However, other services may be more complex and can often be provided either on a stand-alone basis or as part of a package and are linked one way or other to the supply of goods or intangible assets.

D.4.11.2. The following questions are relevant to identify intra-group services requiring arm's length remuneration:

- Have the Indian subsidiaries received any related party services, i.e. intra-group services?
- What are the nature and details of services, including the quantum of services received by the related party?
- Have services been provided in order to meet the specific needs of the recipient of the services?
- Are they duplicate services (i.e., was the Indian subsidiary availing similar services on its own)?
- Did the Indian subsidiary have the capacity to absorb the services provided by the AE?
- What are the economic and commercial benefits derived by the recipient of intra-group services?
- In comparable circumstances, would an independent enterprise be willing to pay for and procure such services?
- Would an independent third party be willing and able to provide such services?

D.4.11.3. The answers to the above questions help in determining if the Indian subsidiary has received or provided intra-group services that require arm's length remuneration. Determination of the arm's length price of intra-group services normally involves the following steps:

- Identification of the cost incurred by the group entity in providing intra-group services to the related party;
- Understanding the basis for allocation of cost to various related parties, i.e., the nature of "allocation keys" used by the MNE;
- Considering whether intra-group services will require reimbursement of expenditure along with mark-up; and

- Identification of the arm's length price of a mark-up for rendering such services.

D.4.11.4. Identification of the services requiring arm's length remuneration is one of the main challenges for the transfer pricing administration. India believes that shareholder services, duplicate services and incidental benefits from group services do not give rise to intra-group services requiring arm's length remuneration. However, such a conclusion would need a great deal of analysis. The biggest challenge in determination of the arm's length price is the allocation of cost by using allocation keys. The nature of allocation keys generally varies with the nature of services.

D.4.11.5. Another challenge for the transfer pricing administration is the identification of pass-through costs, on which mark-ups should either not be paid (if the Indian entity is the recipient of such services) or not received (if the Indian entity is the service provider). Wherever a mark-up is to be paid or received, the determination of an arm's length mark-up is also a challenge.

D.4.11.6. In view of the above facts, transfer pricing of intra-group services is considered a high risk area in India. India considers the payment for such intra-group services to be base-eroding in nature and, accordingly, attaches great importance to the transfer pricing of such payments. Further, even if an arm's length result is achieved in respect of such payments from India, an additional protection in the form of an overall ceiling on the amount of such payments may be required. This may be justified because even an arm's length payment might result in erosion of all the profits of the Indian entity or in enhancement of losses of the Indian entity, thereby, making the arm's length nature of such payments questionable. Thus, an overall ceiling on such payments in the form of a certain percentage of the sales or revenue of the Indian entity is being used in appropriate cases.

D.4.12. Financial Transactions

D.4.12.1. In India, the transfer pricing approach for inter-company loans and guarantees revolves around:

- Examination of the loan agreement;
- A comparison of terms and conditions of loan agreements;
- The determination of credit ratings of lender and borrower;

- The identification of comparable third party loan agreements; and
- Suitable adjustments to the comparables to enhance comparability.

D.4.12.2. The Indian transfer pricing administration has come across cases of outbound loan transactions where the Indian parent has advanced to its AEs in a foreign jurisdiction interest free loans or loans either at LIBOR (London Interbank Offered Rate) or EURIBOR (Euro Interbank Offered Rate). The main issue before the transfer pricing administration is the benchmarking of these loan transactions to arrive at the ALP of the rates of interest applicable on these loans.

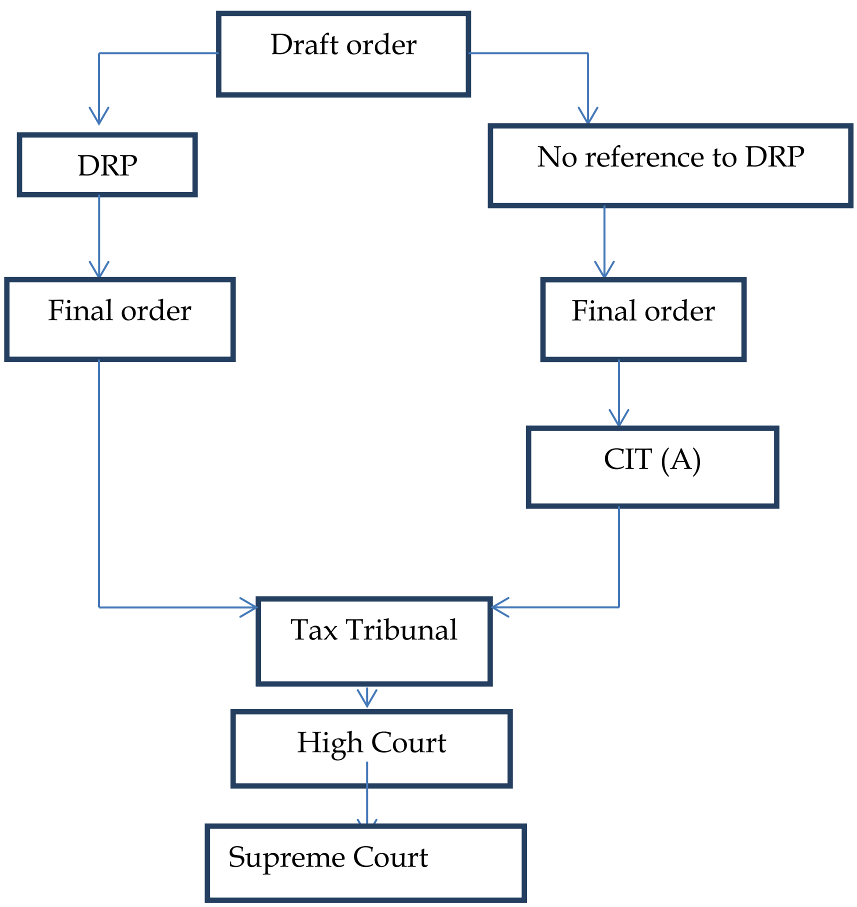
D.4.12.3. A further issue in financial transactions is credit guarantee fees. With the increase in outbound investments, the Indian transfer pricing administration has come across cases of corporate guarantees extended by Indian parents to their associated entities abroad, where the Indian parent as guarantor agrees to pay the entire amount due on a loan instrument on default by the borrower. The guarantee helps an associated entity of the Indian parent to secure a loan from the bank. The Indian transfer pricing administration generally determines the ALP of such guarantee under the Comparable Uncontrolled Price Method. In most cases, interest rate quotes and guarantee rate quotes available from banking companies are taken as the benchmark rate to arrive at the ALP. The Indian tax administration also uses the interest rate prevalent in the rupee bond markets in India for bonds of different credit ratings. The difference in the credit ratings between the parent in India and the foreign subsidiary is taken into account and the rate of interest specific to a credit rating of Indian bonds is also considered for determination of the arm's length price of such guarantees.

D.4.12.4. However, the Indian transfer pricing administration is facing a challenge due to the non-availability of specialised databases and of comparable transfer prices for cases of complex inter-company loans and mergers and acquisitions that involve complex inter-company loan instruments as well as an implicit element of guarantee from the parent company in securing debt.

D.4.13. Dispute Resolution

D.4.13.1. A comprehensive dispute resolution mechanism is available to the taxpayers in India facing transfer pricing adjustments. As a part of the legal process in all cases, the Assessing Officer (AO) incorporates the order of the Transfer Pricing Officer (TPO) in his order and issues a draft order to the taxpayer. The taxpayer has the option to file an objection against the draft order before the Dispute Resolution Panel (DRP) which is a panel comprising three Commissioners of Income-tax. The AO issues a final order in compliance with the DRP's directions. At present, the direction of the DRP is final for the tax administration and it cannot appeal further against the DRP's order. The taxpayer can challenge the direction of the DRP in appellate forums.

D.4.13.2. The sequence and availability of dispute resolution forums to the taxpayer in India is depicted below.



D.4.13.3. The Indian tax administration is aware of the problem of increasing transfer pricing disputes and the impact on the investment climate in India. Therefore, the Government of India has taken several steps to reduce litigation and the time needed to resolve tax disputes. Some of the steps taken in this direction are the following:

- Risk-based selection of cases for transfer pricing audit instead of selecting all cases above a particular monetary limit of the value of international transactions for audit;
- Introduction of the 'Range' concept in the Transfer Pricing Law along with the use of multiple-year data ;
- Use of the Mutual Agreement Procedure (MAP) for speedier resolution of pending cases;
- Introduction of Advance Pricing Agreement (APA) provisions in the law; and
- Introduction of Safe Harbour provisions in the transfer pricing law.

D.4.14. Advance Pricing Agreement (APA)

D.4.14.1. India introduced the Advance Pricing Agreement (APA) provisions in its legislation in 2012. An APA is an agreement between the Central Board of Direct Taxes (CBDT) and any person, to determine, in advance, the arm's length price or specify the manner of determination of the arm's length price (or both), in relation to an international transaction. Once an APA has been entered into, the arm's length price of the international transaction will be determined in accordance with the terms of the APA for the period specified therein. An APA can be entered into for a maximum period of 5 years and can be renewed thereafter. The APA process is voluntary but once an APA is entered into, it becomes binding for both the taxpayer and the CBDT.

D.4.14.2. APAs can be unilateral, bilateral or multilateral. An applicant may request a particular type of APA while making the application. The scheme provides for an optional pre-filing consultation between the taxpayer and the APA team before filing a formal application. Such consultation can be on anonymous basis. The application is to be filed along with the specified fee. The Indian APA Scheme also provides for a rollback of the APA for a period of 4 years prior to the first year of the APA period. Therefore, the combined impact of an APA with rollback provisions is tax certainty for 9 years. Rollback is not available for a year in which the Income Tax Appellate Tribunal (ITAT) has pronounced its decision on the issues proposed to be covered under the APA/Rollback. All the procedures relating to the APA Scheme have been prescribed in detail under the APA Scheme in the Income-tax Rules and certain issues have also been clarified by the CBDT through various Circulars and Frequently Asked Questions (FAQs).

D.4.14.3. The Indian APA program has been well received by the taxpayers and more than 700 applications have been filed in the first 4 years. Almost 100 APAs have already been entered into by the CBDT. The APAs entered into so far cover various sectors of the Indian economy including information technology, automobiles, telecommunications, steel, shipping, general trading, banking, pharmaceuticals, etc. It is expected that the robust APA program in India would go a long way in reducing transfer pricing disputes and providing certainty to MNEs in such matters.

D.4.15. Safe Harbour

D.4.15.1. India has introduced safe harbour provision in its legislation in 2009. Rules for administering the provision were subsequently notified. Safe harbour provisions are intended to reduce the compliance burden for small taxpayers with regard to transfer pricing issues. Sectors/transactions covered under safe harbour rules are the following:

- Software Development;
- IT Enabled Services;
- Knowledge Process Outsourcing Services;
- Outbound Intra-Group loans;
- Corporate Guarantees;
- Contract R&D Services in Software;
- Contract R&D Services in Pharmaceuticals;
- Manufacture and export of core auto components; and
- Manufacture and export of non-core auto components.

D.4.16The Base Erosion and Profit Shifting (BEPS) Final Reports on Actions 8, 9, 10 and 13

D.4.16.1. India has endorsed the final report of the BEPS project on Actions 8, 9 and 10 dealing with various transfer pricing issues. Some of the issues addressed in the BEPS reports, such as the broad objective of aligning transfer pricing outcomes with value creation; giving importance to the Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions in respect of intangibles for remunerating the group entities of MNEs; testing of contractual allocation or contractual assumption of risk on the parameters of exercising control over risk and/or the financial capacity to bear the risk, and disregarding such contractual allocation or assumption of risk; harmonising contracts with the conduct of parties; identifying and accurately delineating the transaction (i.e., identifying the “real deal”) by analysing the economically relevant characteristics; preventing the capital-rich but low-functioning entities (the “cash box” entities) from contributing to base-erosion or profit-stripping; non-recognition of commercially irrational transactions that cannot be seen between independent parties; etc. are in conformity with the long standing views of the Indian transfer pricing administration. Accordingly, the Indian tax administration is of the view that the guidance flowing from the final report of the BEPS project on Actions 8, 9 and 10 should be utilised by both the TPOs and the taxpayers in situations of ambiguity in interpretation of the law. However, India has not endorsed the guidance in the BEPS report pertaining to Low Value Adding Intra Group Services (LVAIGS) under Action 10 and has not opted for the simplified approach.

D.4.16.2. India has also endorsed the recommendations contained in the BEPS final report on Action 13, which attempts to completely change the transfer pricing documentation standards. India has supported the three-tiered documentation regime comprising a Local File, a Master File and a Country-by-Country (CbC) Report and has already carried out legislative changes in its domestic law.

Annex 4

D.5. Mexico Country Practice

D.5.1. Introduction

D.5.11. Mexico introduced transfer pricing rules in 1997 by including the arm's length principal in the Mexican Income Tax Law (MITL). Since fiscal year 2014 the transfer pricing rules are found in Articles 76-IX, 76-X, 76-XII, 179, 180; and 181 and 182. The Transfer Pricing Guidelines for Multinational Companies and Tax Administrations as approved by the Council of the OECD are referred to as applicable in the MITL, for interpretation of the provisions in transfer pricing matters.

D.5.1.2. Tax audits in Mexico may be conducted through on-site inspection of taxpayers to review their accounting, goods and merchandise, or through desk reviews, in which the tax authorities may require that taxpayers submit their accounting records, data and other required documents and information at the offices of the tax authorities. In practice, most audits are conducted through desk reviews.

D.5.2. Related party definition

D.5.2.1. In Mexico two or more individuals or legal entities are deemed as related parties when one of them has a direct or indirect participation in the management, control, or capital of the other, or when a person or a group of persons participate directly or indirectly in the management, control, or capital of such persons. There is no specific threshold for the entities to be considered related parties.

D.5.2.2. In addition, since 2002 members of joint ventures, as well as permanent establishments with regard to their central office or other permanent establishments, are considered related parties. This is in accordance with the provisions of Article 179 of the MITL.

D.5.3. Deemed related party definition

D.5.3.1. It is assumed that any transaction conducted with companies residing in preferred tax regimes will be considered to be carried out between related companies at values other than market values. In addition, it is established that the payments made to residents in such regimes are not deductible; unless it can be proven that the price or consideration amount was settled at market values.

D.5.4. Specific documentation requirements

D.5.4.1. The law in force requires all taxpayers to prepare and keep documentation that proves that all the transactions carried out with related parties are conducted pursuant to the arm's length principle. The transfer pricing documentation must be prepared for each tax year and should have an evaluation per type of transaction and per related party. Mexican related parties are required to provide specific information in the transfer pricing documentation that includes the arm's length intra-group transactions.

D.5.4.2. In addition, taxpayers must also disclose information regarding the conclusions of the transfer pricing documentation studies as part of the appendices of the statutory tax audit report, when this report is applicable.

The transfer pricing documentation must contain the following:

a) Name or firm name of the related company residing abroad;
b) Information relating to assets, functions, and risks per type of transaction;
c) Information and documentation with the detail of each transaction with related parties and their amounts per type of transaction; and
d) Transfer pricing method applied, as well as the documentation of comparable companies or transactions per type of transaction. It is worth mentioning that the range of results obtained from comparable transactions/companies must be the interquartile range.

D.5.4.3. Taxpayers whose income for the immediately preceding tax year was under 13 million pesos in entrepreneurial activities, or 3 million in the provision of services have no obligation to keep and maintain the documentation referred to in the law. This benefit does not apply in the case of transactions with companies residing in preferred tax regimes, or in the case of a transfer pricing information tax return.

D.5.4.4. The same law establishes that such documentation should be recorded in account books, specifying that the transactions were conducted with related parties residing abroad.

D.5.4.5. The Mexican Income Tax Law in force establishes that when using financial information to demonstrate that intercompany prices were agreed at market prices, the taxpayer must prepare such information in accordance with the accounting standard in order to calculate the income, cost, gross profit, net income, expenses and operating profit, as well as assets and liabilities.

D.5.4.6. Through an informative return (DIM 9), taxpayers are also required to submit information regarding transactions with foreign-resident related parties during the immediately preceding year.

D,5,4,7, In addition, companies that are required to file a statutory tax audit report (due on June 30th) must also submit the following appendices with regard to transfer pricing:

- Type and amount of intra-group transactions by related party, transfer pricing method used, whether the intra-group transaction is at arm's length, and amount of the adjustment if so applied to comply with the arm's length principle.

- Business activity of the taxpayer, ownership of intangible assets used, date in which the informative return was submitted and whether the taxpayer has supporting documentation of the arm's length nature of intra-group transactions, Advance Pricing Agreements (APAs) under negotiation, Tax ID of transfer pricing advisors, interest deemed to be dividends, prorata expenses, financial derivative transactions with related parties, thin capitalization issues, corresponding adjustments, etc.

- The external auditors of the Mexican taxpayer filing the statutory tax audit report will also have to complete a transfer pricing questionnaire confirming that all transactions were at arm's length and that documentation requirements were met.

D.5.4.8. The documentation substantiating transfer pricing matters must be prepared every year not later than the date when the annual tax return is filed. In the case of an informative tax return, it has to be filed not later than the date when the statutory tax report is filed.

D.5.4.9. The Mexican tax authorities conduct audits based on information provided by the taxpayer and other data, including information from international databases. A key issue is that this information must be reproducible for purposes of the review.

D.5.4.10. Failing to keep documentary support will result in the external auditor's mentioning of such failure in his report and, in case of an audit, the authority may determine the method and comparable companies it deems appropriate in the application of the arm's length principle, under which an adjustment to the income or deductions may be determined. This may result in a new taxable basis and consequently in a new tax charge including restatement, surcharges, and fines, in addition to the double taxation resulting from the payment made in the other country.

The fine is equal to 100% of the omitted tax (Fraction II of Article 76 of the Federal Tax Code) but it can be reduced to 50% if the transfer pricing study requirement has been met.

D.5.5. Comparability

D.5.5.1. Based on the importance of the arm's length principle applicable in Mexico, the issue of comparability is critical, and includes the five comparability factors that are included in the MITL:

a) The characteristics of the goods and services;
b) The functional analysis;
c) The contractual terms;
d) The economic circumstances; and

e) The business strategies.

D.5.5.2. The MITL establishes the possibility of applying reasonable adjustments to eliminate differences between the comparable transactions or companies. Such adjustments must consider the comparability factors previously mentioned. The application of this comparability adjustment follows the arm's length principle, and can be implemented, for example, as a capital adjustment.

D.5.5.3. Public financial information for local comparables is limited in Mexico. Therefore, the SAT allows taxpayers to use adjusted foreign comparable data. As a result, a taxpayer may argue that the use of foreign company data is acceptable in the absence of reliable local comparable data but it has to be used under strict selection criteria.

D.5.5.4. Under Article 69 of the Federal Tax Code (Código Fiscal de la Federación or FFC), the SAT may use confidential information obtained from third parties to determine the cumulative revenue income and authorized deductions of taxpayers that have not conducted their transactions under the arm's length principle.

D.5.5.5. Once the comparability factors are considered, the most reliable method must be applied which, under the facts and circumstances, provides the most trustworthy measure of an arm's length result. The six methods established in Article 180 of the MITL are basically the same methods included in the OECD transfer pricing guidelines:

1. Comparable Uncontrolled Price Method;
2. Resale Price Method;
3. Cost Plus Method;
4. Profit Split Method;
5. Residual Profit Split Method; and
6. Transactional Net Margin Method.

D.5.5.6. In 2006, resulting from a recommendation from the OECD (as part of the Peer Review of the Mexican Transfer Pricing Legislation and Practices of March 2003) the MITL introduced a hierarchy for the application of transfer pricing methods. In particular, Article 180 of the MITL establishes that taxpayers may use another method only when the CUP method as outlined in the OECD TP Guidelines is not appropriate to determine the arm's-length nature of the tested transaction.

The taxpayer must show that the method used is the most appropriate or most reliable pursuant to all available information, giving preference to the resale price or cost plus method over the profit split or transactional net margin methods.

D.5.5.7. To determine the price that should be used between independent parties, Article 180 of the MITL allows the use of a range of prices or profit margins resulting from the use of a method with two or more comparable transactions. Such range may be adjusted through statistical methods (specifically the interquartile range).

D.5.5.8. The MITL accepts multiple year data only for comparables, and provided taxpayers confirm that the business cycle or the commercial acceptance of the products cover more than one year. The MITL does not allow the use of multiple years if this is only applied as a statistical tool to mitigate normal changes and trends in the financial indicators of the comparables.

D.5.5.9. The MITL transfer pricing rules for intercompany financing focus on the characteristics to consider in applying correct comparability with uncontrolled transactions. These characteristics include the principal amount, payment period, guarantees, debtor's solvency and interest rate.

D.5.5.10. Payments made abroad for interest paid to related parties may be deemed as dividends if they arise from an unconditional promise of payment agreement involving the total or partial payment of credit received, of standby credit, or of a profit-related payment condition; or from the management of the business.

D.5.5.11. Thin capitalization rules are established in Article 28, Section XXVII of the MITL, which states that the interest paid to related parties will not be deductible in amounts exceeding the 3:1 ratio of liabilities to the equity of the company. The rule does not apply to entities that are part of the financial system (as defined in the MITL). Other exemptions and waivers regarding thin capitalization rules may apply. For example, taxpayers who obtain an APA for intercompany loan transactions are not subject to this limitation.

D.5.5.12. In the case of transactions related to the sale or purchase of stocks, the taxpayer must consider elements such as: (i) the equity value of the issuer's stockholders as of the transaction date; (ii) the present value of its profits or cash flows; or (iii) the last published market price of the stock.

D.5.6. Audit Procedure

D.5.6.1. In Mexico, taxpayers must allow inspections to verify tax compliance and provide all documentation requested by the tax authorities. If the tax authorities believe that the taxpayer has not complied with its obligations adequately, the taxpayer must provide all evidence demonstrating such compliance.

D.5.6.2. The burden of proof resides originally with the taxpayer, which must prepare transfer pricing documentation to demonstrate that its transactions are at arm's length. If the tax authorities review this information and find that the taxpayer is not in compliance, the burden of proof is reversed and the tax authorities are liable to determine arm's length prices, considering the information available or otherwise identified for such purposes.

If the dispute goes before the Tax Court, the taxpayer and the tax authorities must present all evidence they deem appropriate to defend their respective positions.

D.5.6.3. The Mexican Tax Administration has recently moved from a centralized approach to a decentralized approach in performing transfer pricing audits where not only the exclusive transfer pricing unit is executing the whole process, but also other audit units in the large taxpayer division and in other areas of the administration are conducting revisions with a holistic approach, which includes transfer pricing along with other taxes such as VAT, withholding taxes, customs, and other local tax provisions, with the coordination and advice of the transfer pricing unit.

D.5.6.4. One of the objectives of the audit program is to deploy revisions for recent years and if possible in real time, taking advantage of recently assembled information, experienced staff and financial resources to streamline the capacity of the tax administration to rectify errors and ensure that the business operations of the taxpayers are in compliance with the tax regime. The tax administration can also monitor the performance of the taxpayers in the post-audit stage. This approach has the additional advantage that for more recent years it would be much easier to understand and outline a value chain analysis of the business for a better resolution of the case.

D.5.6.5. Mexico has started a pilot cooperative compliance program whereby based on principles of trust, transparency and mutual understanding the tax administration look to improve voluntary compliance by taxpayers with their tax obligations., Applying an objective interpretative ("substance over form") criterion which would facilitate and simplify the application of tax provisions, the tax administration aims to establish effective long-term relationships with taxpayers to identify risk areas and use their resources and capacity to find a successful solution. This pilot program is in line with international best practice.

D.5.6.6. Owing to the significant increase in transfer pricing audits and the increase in various taxation issues arising, and the long process for resolving disputes in the courts coupled with the high cost thereof, a new path for mediation during the audit process was created, the Conclusive Agreement. Regarding alternative dispute resolution mechanisms, The Office of the Taxpayer Advocate (Prodecon) arose from the need to strengthen the relationship between the tax authorities and taxpayers, creating a neutral meeting place for agreement and mutual trust.

D.5.6.7. Prodecon aims to protect the rights and guarantees of taxpayers through advice, representation and defense, as well as by receiving complaints and issuing recommendations on tax matters. Other important responsibilities include identification of the endemic problems in the system, holding regular meetings with business and professional associations as well as with trustees and taxpayer organizations, and advising the tax authorities at a high level, proposing corrective action, interpreting tax rules at the request of the SAT, promoting tax culture, and proposing amendments to the tax rules.

D.5.7. Advance Pricing Agreements procedures

Article 34-A of the Federal Tax Code enables Mexican taxpayers to submit issues to the SAT regarding transfer pricing (i.e. APA requests). These can be for unilateral, bilateral or multilateral APAs. The period of validity may cover the year of submission, the preceding year and the following three years. Mutual agreement procedures are also available under the current provisions.

D.5.8. Maquila Export Companies

D.5.8.1. The Maquiladora Program started in the late 1960s as a direct response to the cancellation of the US Bracero Program that had allowed temporary Mexican migrant agricultural workers into the US for seasonal employment. The Mexican and US governments agreed to the maquiladora program whose immediate purpose was to provide employment in Mexico and generate economic activity in the manufacturing industry. It was not initially constructed for purposes of taxation, multilateral trade treaties, or long-term foreign direct investment.

D.5.8.2. In 1989, the Mexican government issued a decree to adapt and aggressively expand the maquiladora program, with the intention of moving beyond simple job creation into a more meaningful economic development of the Mexican manufacturing and export generation base. The expansion program was intended to develop a local supply chain for US manufacturers and to include a qualification program (PITEX Program) for Mexican companies to produce and supply some of the inputs for the US companies (unlike maquiladoras that import all inputs).

D.5.8.3. A maquiladora is a Mexican subsidiary company, usually 100% foreign-owned, whose primary role is assembly. Maquiladoras are defined in the Presidential Decree (*Decrees for the Fostering and Operation of the Maquiladora Industry for Export*) as assembly plants undertaking maquiladora activities under permit by the Ministry of Economy.

D.5.8.4. Maquiladoras are usually structured as costs center, with marginal profits. Their activities include the maintenance of assets and inventories provided by foreign residents for their transformation (production, sub-assembly and assembly) by maquiladoras into semi-finished and finished goods destined for exports (mainly for the United States market). Typically, foreign parent companies own inventories, equipment and machinery, provide the maquiladora with all the input, technology and know-how to carry out the manufacturing process, and allow the maquiladora the use of patents and technical assistance free of charge. Maquiladoras usually own or lease some assets, including a physical facility in Mexico; they hire and manage the labor pool required, and use capital free-loaned from the parent company to transform inputs into products for export to the parent company or another related party. Many maquiladoras actually perform additional functions for the parent company. However, maquiladoras are generally treated as “contract” companies in the sense that they are assumed to perform functions requiring no valuable intangibles and very few routine intangibles.

D.5.8.5. Parties residing abroad may constitute a permanent establishment in Mexico arising from the legal or economic relations with Maquila export companies.

D.5.9. Current Maquila Provisions

D.5.9.1. The entities carrying out maquila operations are expected to comply with the arm's length principle, and the foreign residents for which the maquila operates will not be treated as having a PE if the maquiladoras determine their taxable profit according to "Safe Harbor" rules.

Under this measure, the Maquila companies have to obtain a taxable profit that represents at least the larger of the values of:

a) 6.9% on the assets used in the Maquila activity, both its own and those of the party residing abroad, or
b) 6.5% on the costs and expenses incurred by the Maquila company.

D.5.9.2. This option has remained the same since the year 2000. For purposes of this option, the obligation to the Tax Administration Service (TAS) is to file an informative return declaring that the taxable profit obtained represents at least the greater amount resulting from applying the 6.9% or 6.5% calculations as referred to above, corresponding to the safe harbor option.

D.5.9.3. These rules include several provisions for existing and newly organized maquiladoras with respect to the determination and valuation of the asset base and cost base (i.e. adjustments for inflation, amortization, inventory and currency conversion; exclusion for shelter activities, timeframes, documentation requirements, conditions for changing options, etc.).

D.5.9.4. Also, the entity resident in Mexico can submit an APA application to confirm compliance with the arm's length principle, and that foreign residents would be exempted from PE status, The APA may be requested under the rules of Article 34-A of the Federal Tax Code. This possibility offers greater legal certainty to those taxpayers who take it.

D.5.10. Competent Authority Procedure

Any transfer pricing determinations done in any country that represent a modification of the cumulative income or deductions of a Mexican taxpayer may be performed solely by filing an amendment tax return, providing that the Mexican tax authority has accepted such adjustment, validated through a competent authority procedure with a tax treaty in place.

D.5.11. Effective Implementation of the Arm's Length Standard

D.5.11.1. The main pillars of an effective implementation of the arm's length standard are comprehensive legislation, trained and adequate personnel, control procedures and a robust, systematic and precise risk assessment system.

D.5.11.2. Mexico recognizes that a well-founded risk assessment system is the correct starting point of an effective tax audit cycle, and in this regard a series of tax structures and arrangements have been identified by the Mexican Tax Administration and tackled by implementing specific audit programs. This relates to the causes and effects of eroding structures, which from a transfer pricing perspective have an impact on operating results, net results and tax results of non-reported intercompany income, involving base eroding payments (including those settled with low tax jurisdictions) and business restructurings (assets and risk reallocations).

D.5.11.3. It has been recurrently noted by Mexican tax officials that intra-group service transactions are a risk area, and in 1981 the Mexican Income Tax Law was reformed to include a limitation of the deduction of prorated expenses. Nonetheless in 2014, the Mexican Supreme Court ruled that the limitation of the deduction of prorated expenses is neither absolute nor unrestricted, thus the deduction may be permitted if certain conditions are fulfilled, namely that the service transaction has been rendered, that it provides a benefit to the recipient and that it conforms to the arm's length principle.

D.5.11.4. Information asymmetry is at the core of the problems of effectively documenting an intra-group service transaction so it is crucial that taxpayers provide appropriate information on the service rendered, the service provider entity (even if it is foreign entity), and the benefit test. It would also be useful to make a general assessment of the financial status of the service recipient entity, which must have the financial capacity to bear the expense; and it has been important to clarify to taxpayers in Mexico that in the absence of the appropriate information to document an intra-group service transaction the expenses can be non-deductible under the Income Tax Law.

D.5.11.5. Royalties paid to nonresident related parties for the temporary use or enjoyment of intangible assets are likely to be challenged when such royalties are from a Mexican source and were previously owned by the taxpayer or any related party thereof residing in Mexico, when the transfer of the intangible assets was made without receiving any consideration or at a below-market price.

D.5.11.6. Recently the SAT has challenged the fact pattern where there are advertising and marketing expenses (AMP) incurred by the Mexican subsidiaries along with royalties paid to their related parties abroad for marketing intangibles, since the legitimate owners of the intangibles surplus are the ones creating them. These are mostly the entities in charge of the development of brand awareness, brand positioning, and brand prestige adding value to the business cycle.

D.5.11.7. Mexican subsidiaries should be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles.

D.5.11.8. Two of the key components of the aforementioned transactions are the economic valuation of the intangible assets and the amount of the royalty payments arising from the use of such assets. Both elements should be analyzed under the tax regulations on transfer pricing in force since 1997.

D.5.11.9. In Mexico as in many countries taxpayers tend to over-utilize net margin TP methods to support the Mexican company's financial results (regardless of a careful review in establishing the tested party), collecting external comparables operating in the same industry from commercial databases, mostly from developed countries such as United States and Canada, since public data from local comparables is scarce due to the low market capitalization in Mexico. Since in most industries the macroeconomic conditions between Mexico and developed countries such as the United States and Canada differ it is necessary to perform comparability adjustments to the financial results of the comparables.

D.5.11.10. The application of a comparability adjustment follows the arm's length principle, and this can be implemented as a capital adjustment if you measure the inherent differences between the sovereign bond yields of the two countries – the country of the tested party and the country of the comparable – and apply it as a factor in the invested capital or operating assets of the companies. Even though a country risk adjustment would generally improve the comparability of the companies in this situation, there can be specific industrial differences among countries which must be evaluated independently. Another separate comparability adjustment may come from local saving advantages.

D.5.11.11 An aggressive tax planning structure found in Mexico relates to full manufacturing companies performing all productive processes from purchase of raw materials, manufacturing the products, product development and incorporation of intangibles, searching for clients, selling the finished products to the clients, and assuming all related risks in the Mexican market; and suddenly the company is included in the maquiladora regime and also presumably acts as a limited risk entity only receiving compensation through a markup over salaries, and a minimal commission for the sales to the retailers, despite having the same functions as before the reorganization.

D.5.11.12. These reorganizations are being challenged following the 2014 tax reform under which maquila companies must export all of the products they produce, and if the products are found to be sold in Mexico, the value chain, even if fragmented, would be assessed and taxed in its entirety in Mexico, including the manufacturing and distribution portions of the business performed in Mexico.

D.5.12. Recent developments

D.5.12.1. The Mexican Tax Authority is committed to implementing the Base Erosion and Profit Shifting (BEPS) initiatives. As such, and in the context of transfer pricing, the documentation package contained in Action 13 (Transfer Pricing Documentation and Country-by-Country (CbC) Reporting); that is, the initiative to request mandatorily from taxpayers the Master File, Local File and CBC Report has recently been approved by the country's lawmakers.

D.5.12.2. Also, regarding Mandatory Disclosure Rules (Action 12), the SAT established in 2014 a form to be completed by taxpayers regarding "relevant or significant transactions" (Form 76, Article 31-A of the Federal Tax Code). This reporting must be filed quarterly with the SAT. The main categories of transactions that have to be reported in Form 76 are:

- Financial transactions as provided in Articles 20 and 21 of the Mexican Income Tax Law (derivatives);
- Related party transactions that require an adjustment on the price/value of the transactions;
- Capital participations and tax residence;
- Reorganizations and restructures; and
- Other relevant transactions (intangibles, financial assets, tax losses from demergers or spin offs, etc.).

Five of the 36 transactions listed in the file provided by the tax authorities are related to transfer pricing, specifically with adjustments and royalty payments.

Annex 5

D.6. SOUTH AFRICA - COUNTRY PERSPECTIVE

D.6.1. Introduction

Over the last few years transfer pricing has been and still is a strategic focus area for the South African Revenue Service (SARS) forming an integral part of SARS's Compliance Programme. International developments around the transfer pricing practices of large multinationals that have been made public together with the G20/OECD BEPS Project have resulted in transfer pricing having a heightened focus not only for SARS and South Africa's National Treasury but also at the highest levels of government. Labour unrest in the extractive sector saw NGOs and civil society, together with some political parties, attributing the inability of corporates to pay fair wages to be the direct result of transfer mispricing and profit shifting.

D.6.2. South African Transfer Pricing Law

By way of background, South Africa's transfer pricing legislation (set out in section 31 of Income Tax Act 58 of 1962) came into effect on 1 July 1995 followed by Practice Note 2 (published on 14 May 1996) and Practice Note 7 (published on 6 August 1999) which served to provide taxpayers with guidance on how SARS interpreted the legislation. Practice Note 2 covered thin capitalisation whilst Practice Note 7 dealt with transfer pricing. With effect from 1 April 2012 several legislative amendments to the transfer pricing rules became effective. However, the fundamental principle underpinning the South African transfer pricing legislation, since inception, has been the arm's length principle as set out in Article 9 of both the United Nations Model Double Taxation Convention between Developed and Developing Countries and the OECD Model Tax

Convention on Income and on Capital, as well as the UN Practical Manual on Transfer Pricing for Developing Countries and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Transfer Pricing Guidelines). It is the stated intention of SARS to review Practice Note 2 and Practice Note 7 to take into account the legislative amendments mentioned above.

Given the strategic importance of transfer pricing to SARS, there has been significant progress in refining and improving the administration of transfer pricing and the application of the arm's length principle. Whilst resourcing and skills challenges remain, active measures are being taken by SARS to build capacity in the transfer pricing unit.

This country experience's is not an affirmation of SARS' approach to all transactions as this remains circumstance and fact specific.

D.6.3. Recent Transfer Pricing Developments in South Africa

D.6.3.1. The Davis Tax Committee

South Africa's Minister of Finance announced in February 2013, that the government would initiate a tax review to assess South Africa's tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability. A nine member committee known as the "Davis Tax Committee" (DTC) was inaugurated and the Committee's Terms of Reference were announced in July 2015.

In September 2013 the G20/OECD BEPS Project was launched with South Africa participating as an equal partner. As a result, the DTC set up a BEPS Sub-Committee to address its concerns around base erosion and profit shifting and formulate the DTC's position in this regard. The DTC consulted with various stakeholders from business representatives, trade unions, civil society organisations, tax practitioners, SARS, National Treasury, the South African Reserve Bank, members of international bodies and academics, in releasing its "BEPS First Interim Report" for public comment by 31 March 2015.

In this release, the DTC made recommendations for South Africa regarding transfer pricing in general and recommendations in relation to Actions 8 and 13 of the G20/OECD BEPS Project around intangibles and documentation.

a) General Recommendations

The general recommendations included the following:

- formal adoption of the OECD Transfer Pricing Guidelines through a Binding General Ruling, as provided for in section 89 of the Tax Administration Act of 2011;
- the suggested Binding General Ruling should include a set of principles reflecting the South African reality;
- SARS must increase its enforcement capability within the transfer pricing unit; and
- SARS must ensure that there is sufficient transfer pricing training and capacity building in its transfer pricing unit.

b) Action 8 – Intangibles

With regards to intangibles the recommendations of the DTC focussed on:

- the transfer pricing implications associated with foreign owned intellectual property (IP) which is licensed to South African related parties, and;

- the transfer pricing implications associated with South African owned IP which is made available to foreign related parties.

The DTC acknowledged the role of the South African Exchange Control (governing sales and transfers of South African owned and developed IP and outbound royalty payments), the Department of Trade and Industry (which regulates royalty rates for IP associated with a process of manufacture) and the South African Reserve Bank (governing all other royalty payments). The DTC also analysed situations involving IP that, despite governance, controls and specific anti-avoidance regulations, could nonetheless, lead to base erosion and profit shifting through business restructurings, treaties and artificial creation of substance. Against this backdrop the DTC made the following observations/recommendations:

- No immediate need for South Africa to enact legislation to prevent transfer pricing of intangibles since the current exchange controls restrict the outbound movement of intangibles and royalty payments;
- That careful consideration should be given in the event of any future developments or relaxation of the exchange control rules for IP. The DTC suggested that any policy development in this area should be informed by tax and specifically the transfer pricing considerations;

- Given that South African developed IP cannot be readily exported without the necessary regulatory approvals, the DTC recommended that:

  - The South African CFC rules exclude intangibles from the CFC exemption benefits;

- The transfer pricing rules or even the general anti-avoidance provisions of the Income Tax Act be applied to challenge the limited remuneration of a South African entity involved in the IP development process;
- Use should be made of section 23I of the Income Tax Act (an anti-avoidance provision) which prohibits the claiming of an income tax deduction in respect of "tainted IP".
- The "beneficial ownership" in terms of the royalty article 12 of DTAs can also be applied to deny the reduced withholding tax treaty rate if the recipient lacks substance.

Overall, whilst the DTC remained concerned regarding tax structuring around IP and its potential for base erosion and profit shifting, the DTC also included some cautionary language that:

"Care should be taken, when developing tax legislation on transferring of intangibles, to ensure that the legislation is not so restrictive that it limits South Africa's ambitions to be a global player in the development of IP".

c) Action 13 – Documentation

The DTC made the following recommendations:

- SARS should prioritise updating Practice Note 7 in line with the OECD transfer pricing documentation guidelines and provide taxpayers with much more specific guidance on what information is actually required;
- preparation of a local file, a master file and country by country (CbC) reporting should be a compulsory requirement for South African groups with turnover in excess of R1 billion;

- a strengthening of the confidentiality provisions of the Tax Administration Act;
- SARS must balance requests for documentation against the expected cost and compliance burden to the taxpayer of creating it;
- SARS should clarify its expectations with respect to the timing of preparation and filing of the master file, local file and CbC Report;
- it is not necessary for SARS to provide additional requirements with respect to the general retention of documents except to the extent that it is considered necessary to have rules which are specific to transfer pricing documentation;
- SARS should implement the OECD's recommendation that the master file, the local file and the country-by-country report should be reviewed and updated annually and that database searches for comparables be updated every 3 years;
- SARS should consider an incentive programme to encourage compliance with transfer pricing documentation requirements;
- SARS should build a database of comparable information;
- SARS should establish a highly skilled transfer pricing team to include not only lawyers and accountants but also business analysts and economists, to ensure an understanding of commercial operations. This will require that measures are taken to identify, employ and retain skilled personnel especially in the regions;
- SARS should improve the corporate income tax return;
- the collection and sharing of data should be extended to include other holders of vital information such as exchange control information about capital outflows collected by the South African Reserve Bank.

In conclusion, after review and evaluation, SARS has implemented certain of the DTC recommendations relating to documentation, tax returns and building capacity in the transfer pricing division.

D.6.4. The G20/OECD BEPS Project

South Africa is not a member of the OECD but has the status of being a participant in the Committee on Fiscal Affairs. However, as part of the G20/OECD BEPS Project, South Africa was an associate on equal footing alongside OECD countries.

For South Africa, the BEPS Project was a welcome initiative and created a platform for many developing countries to bring to the fore their challenges with the positive prospect of solutions. The BEPS Project raised areas of improvement for South Africa, especially that of asymmetry of information, resulting in legislative and administrative changes.

D.6.5. Legislative and Administrative Amendments and Proposals

The following significant changes have been made to the Tax Administration Act, 2011, in South Africa. At a glance these relate to:

a) Filing of CbC reports;
b) Access to information;
c) Extension of the statute of limitations to audit certain classes of BEPS related transactions, including transfer pricing; and
d) Expanding the corporate tax return to improve and increase disclosure requirements of transfer pricing and other BEPS related transactions.

D.6.5.1. Country-by-Country Reporting

Following final outcomes contained in the OECD CbC report, South Africa remains committed to adhere to the agreed framework of the CbC report. Legislation has been passed to ensure the filing and sharing of CbC reports.

1D.6.5.2. Access to Information

One of the key challenges in any transfer pricing analysis is access to information. This is a widespread problem not unique to South Africa and indeed was also acknowledged in the BEPS project. Over the past two years SARS has been challenged on a number of fronts regarding its information requests including, *inter alia*:

- SARS's right to certain categories of information. Taxpayers have argued for the non-submission of information on the basis that such information is commercially sensitive, irrelevant and out of scope, not accessible, or legally privileged;
- Taxpayers requesting numerous extensions of time within which to comply with a SARS information request to the point that the statute of limitation runs out for SARS or that it becomes almost impossible for SARS to review such information before the statute of limitations runs out; and
- Taxpayers have challenged SARS's powers to interview persons and personnel that may have information relevant to the transaction under audit.

To address these challenges, the following legislative amendments have been effected to the Tax Administration Act:

a) The overarching provisions of section 46 clarify the information gathering powers of SARS to be that SARS can request information that is relevant or foreseeably relevant. There is no onus on SARS to explain or justify information requests. However, it was acknowledged that legal professional privilege was an exceptional situation. For this reason section 42A was introduced clarifying the ***requirements*** to be met by taxpayers failing to submit relevant information to SARS on the basis of legal professional privilege and the ***process*** to be followed to resolve the issue;

b) Amendment to section 46 with respect to access to foreign based information and to ensure that where a matter progresses to dispute resolution taxpayers are held to any assertions that they were unable to access information located offshore. Where a taxpayer makes such an assertion, the taxpayer may, under certain circumstances, be prohibited from submitting such information at a later stage;

c) Amendment to section 47 clarifying persons who may be interviewed or called upon to provide information on a taxpayer/company/entity under audit. Important to this amendment is the existing requirement in terms of section 49 of the TAA, that allows SARS to request such persons to be interviewed under oath or solemn declaration; and

d) A record keeping notice in terms of section 29 of the Tax Administration Act was issued on [?? October 2016[21] - *to be updated when final notice is published*], requiring specified persons to keep and retain the records, books of account or documents prescribed in the schedule to the notice. That public notice sets out additional record-keeping requirements for transfer pricing transactions.

D.6.5.3. Extension of Prescription

Previously there was a general 3 year statute of limitation for assessments by SARS to execute and conclude any audit, including audits relating to transfer pricing. In

[21] http://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-49%20-%20Draft%20Notice%20in%20terms%20of%20section%2029%20of%20Tax%20Administration%20Act%20Second%20Round.pdf

response to taxpayers requiring continuous extensions of time that impinge on the statute of limitation period together with the recognition of the need for taxpayers to have sufficient time to collate information, amendments to section 99 of the TAA were made extending the prescription period by the period of delay by the taxpayer in responding to a request for information by SARS, and a further 3 years where an audit or investigation relate to transfer pricing, the application of substance over form, the general anti-avoidance rule or the taxation of hybrid entities or hybrid instruments.

D.6.6. Comparability

The main challenge that South Africa has in determining arm's length profits has to be the lack of domestic comparables. It is thus accepted that the *most reliable* comparables will suffice. The problem in South Africa is that this compromise is extended even further given that there are no databases containing South African specific or for that matter, Africa specific, comparable data. As a result, both the tax administration and taxpayers rely on European databases to establish arm's length levels of profitability.

The obvious problem this gives rise to has no simple or definitive solution. Instituting comparability adjustments to account for geographical differences (for example, market, economic and political differences) in order to improve the degree of reliability of the comparable data, is often extremely complex and can in some instances have the reverse effect, i.e. where the comparable data is no longer comparable.

In practice, SARS has attempted to make comparability adjustments, for example country risk adjustments based on publicly available country risk ratings and government bond rates (sometimes referred to as the risk free rate). However, these have been applied with caution and in specific circumstances.

Whilst South Africa may be worse off than some countries for not having any domestic comparable data, many other countries are likely to be in a similar position. As multinationals become more and more complex in their business models and as more widespread industry consolidation is achieved, finding comparable data and achieving reliability may not be South Africa's problem alone. It is perhaps already true that for certain types of large scale manufacturing and distribution activities, for example, in the automotive industry there is no independent comparable data available anywhere.

It is for this reason, amongst others, that SARS favours a more holistic approach to establishing whether or not the arm's length principle has been complied with. By seeking to understand the business model of taxpayers across the whole value chain, gaining an in-depth understanding of the commercial sensibilities and rationalities governing intra-group transactions and agreements it is evident that SARS does not look to comparable data alone or in isolation from other relevant economic factors in determining whether or not the appropriate or arm's length level of profit has been achieved.

An important development in the BEPS Project was the undertaking by the OECD to develop toolkits for developing countries. One of them relates to further work to be done in the area of comparability. SARS is working with the OECD work groups in this regard in the hope that meaningful solutions may be found. In the interim SARS continues to work with service providers of comparable databases to develop possible solutions to address the challenge

D.6.7. Services

As a result of an increase in globalisation, in order to achieve economies of scale and optimise efficiencies, it is becoming commonplace for multinationals to centralise the provision of certain services in a single entity, generally in a tax favourable jurisdiction.

The challenge in establishing whether or not payment for a service is arm's length goes further than the two step approach set out in Chapter 7 of the OECD Guidelines. Whilst Chapter 7 was covered in the BEPS Project, it has largely remained the same with the exception of the introduction of a simplification measure relating to low value adding services. Overall, there were no significant developments to address the BEPS challenge that service payments present for developing countries.

South Africa has consistently stated that it will not be applying the simplified approach to low value adding services, as outlined in the final BEPS report.

In essence, Chapter 7 continues with the approach that in establishing the arm's length nature of intra-group services, the test is twofold. Firstly, it must be determined if a service has been rendered and secondly it must be determined if the charge for such service is arm's length (paragraph 7.5 of the OECD Transfer Pricing Guidelines). As relates to the first part of the test, the approach followed is to determine if the services:

- Provide the recipient with economic and commercial benefit (now called the "Benefits Test" in the revision to Chapter 7);
- Are not services that the recipient is already performing for itself (duplicate service test); and
- Are not shareholder services.

As regards the second part of the test, the audit approach seeks to confirm the following:

- That the cost base is appropriate to the services provided;
- That the mark-up is arm's length; and
- That the allocation keys applied are commensurate to the services provided.

In particular paragraph 7.29 of the OECD Transfer Pricing Guidelines states that in determining the arm's length price for intra-group services, the matter should be considered from the perspective of the service provider and the recipient. Relevant considerations include the value of the service to the recipient as well as the costs to the service provider.

With regard to the determination of whether or not a service has provided the recipient with economic and commercial benefit, demonstration of adherence to the arm's length principle becomes difficult. In practice this is becoming more and more subjective. The economic benefit of services cannot always be measured in actual monetary or other quantifiable terms and as such it is often becoming more the "say so" of the taxpayer rather than a matter of fact. It is often reiterated that transfer pricing is not an exact science and tax administrations are encouraged to take into account the taxpayer's commercial judgement as well as their own. This becomes difficult when that judgement has the potential to translate into a significant tax adjustment for taxpayers. A possible solution is for a tax administration to clearly set out its documentation and burden of proof requirements. However, this is likely to meet with resistance from taxpayers claiming that this places an increased compliance cost burden on them. SARS is currently taking a pragmatic but firm approach to evaluating payments for intra-group services and where clear commercial justification or reasonableness for those payments is lacking, the payments are disallowed.

1. D.6.8. Contract Risk Shifting - Year-End Adjustments

There appears to be an increasing tendency for parent companies of South African subsidiaries to shift profits via a year-end adjustment to either the cost of goods imported by the South African subsidiary or directly to the operating margin, to bring the South African subsidiary in line with "comparable companies". What occurs is usually a global policy change by the parent company aimed at limiting the return of its subsidiaries (including those based in South Africa) to a guaranteed return (determined by way of a comparable search). The change in policy is often followed by an introduction of year-end transfer pricing adjustments to ensure that South African entities achieve the often low targeted net margin while the residual profit is returned to the parent or holding company.

There is little or no regard for the drivers of higher profits attained in South Africa when comparing them to comparable companies in foreign markets (given there are no local comparables for South Africa) or consideration for the actual functional and risk profile of the South African subsidiary. South African subsidiaries of multinational companies are frequently classified as limited risk distributors or limited risk manufacturers when in actual fact they assume much more than just limited risk. Furthermore, there are many instances where unique dynamics exist within the South African market that enable South African subsidiaries to realise higher profits than their related party counterparts in other parts of the world or than is evidenced by comparable data obtained from foreign databases. For instance, the South African pharmaceutical and manufacturing industries are still unsaturated and offer ample opportunities for multinational companies to increase their profits. The increased participation and spending power of the middle class segment in the economy also offers a new market opportunity for certain industries.

Building on the practice followed in India and China, SARS is currently considering its approach to location savings, location specific advantages and market premiums within certain industries and those factors will be addressed when conducting audits.

D.6.9. Intangibles

As intangibles are “unique” in nature they raise unique transfer pricing challenges for both multinationals and tax administrations. Disputes which arise in South Africa relate to the existence of local marketing intangibles, issues of economic versus legal ownership and the valuation of intangibles. The revised guidance in Chapter 6 of the OECD Transfer Pricing

Guidelines as a result of the BEPS Project was welcome and provides helpful guidance for developing countries.

In the South African experience, the sale of South African developed intangibles presents a somewhat exceptional situation compared to the rest of the world, as exchange control regulations prohibit the relicensing of that intangible property back into South Africa. Once the intangible property is sold to an offshore related party, usually in a low tax jurisdiction, the related party becomes the legal owner of the intangible property. This related party then licences out the intangible property worldwide (excluding South Africa) earning royalties. In addition, terms and conditions of the original sale may dictate that the South African entity will continue to perform certain functions toward the enhancement and further development of the intangible property for which it earns a cost plus return. The related party, that is now the legal owner, in essence merely carries out activities relating to registration and maintenance of the intangible property and earns an intangible related return (in the form of royalties). Furthermore, if such intangible property were ever sold outside of the group, the South African entity would have no participation in any profits that may be realised.

In this regard the SARS will be applying the guidance arising from Action 8 of the BEPS Project.

D.6.10. Safe harbours and Advance Pricing Agreements (APAs)

In SARS the view is held that the use of safe harbours and APAs should be considered with caution. For developing countries the introduction of safe harbours is perhaps best considered when the tax authorities have established a high degree of understanding of certain transaction types with low risk. Most often, the benefits of safe harbours are considered to include ease of audit administration, without due consideration to the resultant quantum of the possible tax leakage that can arise from the application of safe harbours. For this reason, it is important that countries give careful consideration to what they will be sanctioning when introducing safe harbours.

With respect to an APA program, despite its obvious benefits such as co-operative compliance and resolution, there are also significant pitfalls. For any tax regime considering an APA regime there must be a balance between providing certainty to taxpayers and ensuring effective administration and tax collection by the tax administration. An important consideration in the light of scarcity of resources is whether to build audit or APA capacity. For developing countries with fledgling transfer pricing regimes, there need to be safeguards against offering APAs without having developed key knowledge of how transfer mispricing occurs in certain industries, transaction types or countries. Given that practically an APA consideration is similar to an audit approach, it stands to reason that a country with little audit capability should not be entering into APAs.

The key message is that whilst safe harbours and APAs have their respective benefits, they should be equally beneficial for the tax administration and taxpayers.

D.6.11. Conclusion

The arm's length principle presents several challenges in terms of application. The hypothesis required to approximate transactions between related parties to what would have transpired had they been independent can be difficult and as stated, finding reliable comparables and making comparability adjustments is easier said than done.

For now there is no disagreement that the arm's length standard is the most workable solution despite some of its limitations which can be overcome. In the South African context, whilst taxpayers may seek to exploit the limitations of the arm's length principle to their advantage, SARS remains undeterred. The arm's length principle does not ignore basic principles such as the perspective of the prudent business man, commercial rationale and good business practice. It is with this understanding that SARS applies the arm's length principle.