

## 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, as outlined in Part A of this Manual.

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<sup>1</sup> 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

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<sup>1</sup> The component parts of an MNE group, such as companies, are called “associated enterprises” in the language of transfer pricing.

pricing therefore refers to the setting of prices<sup>2</sup> for transactions between associated enterprises involving the transfer of property or services. These transactions are also referred to as “controlled” transactions, as distinct from “uncontrolled” transactions between companies that are not associated and can be assumed to operate independently (“on an arm’s length basis”) in setting terms for such transactions.

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.

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<sup>2</sup> However, in most cases the transfer pricing analysis will end after an appropriate profit margin has been determined. See Chapter B.3 on Transfer Pricing Methods.

- 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”<sup>3</sup> 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; 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

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<sup>3</sup> Insurance companies within a group having the specific objective of insuring group risks.

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 Chapter B.3.) that may be used under the OECD Guidelines in various situations to arrive at an arm's length price. However, while these methods may be able to provide a computation of the arm's length price (i.e., an appropriate transfer price) within the MNE, in practice disagreements between tax 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".<sup>4</sup> Under

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<sup>4</sup> See, for more detail,  
[http://ec.europa.eu/taxation\\_customs/taxation/company\\_tax/common\\_tax\\_base/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm)

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<sup>5</sup> 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.<sup>6</sup> 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.<sup>7</sup>

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:

(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

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<sup>5</sup> A committee formed by the European Commission, consisting of representatives of EU Member States and private sector representatives.

<sup>6</sup> Available from [unctc.unctad.org/data/e88iia6b.pdf](http://unctc.unctad.org/data/e88iia6b.pdf)

<sup>7</sup> Available from [unctad.org/en/pages/PublicationArchive.aspx?publicationid-348](http://unctad.org/en/pages/PublicationArchive.aspx?publicationid-348)

of these conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly”.<sup>8</sup>

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,<sup>9</sup> 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.

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:

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<sup>8</sup> United Nations, New York 2011. Available from [http://www.un.org/esa/ffd/documents/UN\\_Model\\_2011\\_Update.pdf](http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf)

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

- 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<sup>10</sup> 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.

B.1.4.16. The above processes are discussed in detail in Chapter 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 Chapter B.3. It is, however, important to note at the outset that there is no single transfer pricing method which is generally applicable in every possible situation.

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

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<sup>10</sup> See the Brazilian approach at Chapter D.2.

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 Chapter 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 Chapter 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 development (or acquisition from third-parties) of the

intangibles, the enhancement, maintenance, protection and exploitation 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.** Chapter 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, Chapter 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, Chapter 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**

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 Chapter 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 Chapter 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**

B.1.8.1. The OECD Model Convention<sup>11</sup> 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.<sup>12</sup> 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.

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<sup>13</sup> 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

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

<sup>12</sup> The UN Model is available from [http://www.un.org/esa/ffd/documents/UN\\_Model\\_2011\\_Update.pdf](http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf)

<sup>13</sup> Officials designated by countries to discuss treaty and other international tax-related issues with each other.

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 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. Chapter 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.<sup>14</sup> Further, the EU Arbitration Convention<sup>15</sup> 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.

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<sup>14</sup> A paragraph relating to arbitration has also been included in Article 25 of the OECD Model Tax Convention.

<sup>15</sup> Convention 90/436/EEC 1990.

## **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 Chapter B.2; 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 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, as a response to the increasing globalization of business and the concern that this may be abused to the detriment of countries without such legislation. Many other countries depend on anti-avoidance rules to deal with the most abusive forms of transfer pricing; see further Chapter 3 Part B.8 on the General Legal Environment legislative design principles for a transfer pricing regime.

### **B.1.9. Transfer Pricing as a Current and Future Issue**

#### **General issues with transfer pricing**

B.1.1. Several issues arise when applying the arm's length principle to the domestic realities of developing countries. The high level of integration of international enterprises, the proliferation of 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.

### **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. Chapter 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 Chapter 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.