

## ***Background Paper***

### ***Working Draft***

## **Chapter 9**

### **Documentation**

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

#### **I. Introduction**

Adequate documentation will make it easier for tax authorities to review a taxpayer’s transfer pricing analysis and thereby contribute to avoiding a dispute or timely resolution of any transfer pricing disputes that may arise. Adequate documentation is characterised by (i) the sufficiency of the details demonstrating the taxpayers’ compliance with the arm’s length principle, as well as (ii) the timely manner in which such details are prepared and submitted to tax authorities upon their request.

A taxpayer should make reasonable efforts to undertake an adequate transfer pricing analysis to ascertain the arm’s length pricing, as well as to show clearly that such analysis has been actually conducted. Activities undertaken to prepare and maintain appropriate documents with a view to conforming to the arm’s length principle can be referred to as the “arm’s length documentation”.

This Chapter first introduces some existing international guidelines on transfer pricing documentation, which will be helpful in browsing general issues on transfer pricing documentation. It is then followed by a more in-depth discussion on several topical issues frequently raised in the process of TP documentation, with the goal of providing practical guidance on such issues. An annex to this Chapter will set forth selected countries’ legislation examples on TP documentation and a Sample TP Study.

#### **II. International Guidelines on Transfer Pricing Documentation**

##### **1. OECD Transfer Pricing Guidelines (2010)**

The OECD’s guidance on documentation is well summarized in the following paragraphs of the 1995 (and now 2010) versions OECD Transfer Pricing Guidelines:<sup>1</sup>

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<sup>1</sup> As noted elsewhere in this Manual, the Commentary to Article 9 of the UN Model recommended acceptance of the 1995 Guidelines in applying the “arm’s length principle enshrined in Article 9. The 2010 Guidelines reproduce the 1995 Guidelines on the documentation issues.

5.28 Taxpayers should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm's length principle. Tax administrations should have the right to obtain the documentation prepared or referred to in this process as a means of verifying compliance with the arm's length principle. However, the extensiveness of this process should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. Moreover, the need for the documents should be balanced by the costs and administrative burdens, particularly where this process suggests the creation of documents that would not otherwise be prepared or referred to in the absence of tax considerations. Documentation requirements should not impose on taxpayers costs and burdens disproportionate to the circumstances. Taxpayers should nonetheless recognize that adequate record-keeping practices and voluntary production of documents facilitate examinations and the resolution of transfer pricing issues that arise.

5.29 Tax administrations and taxpayers alike should commit themselves to a greater level of cooperation in addressing documentation issues, in order to avoid excessive documentation requirements while at the same time providing for adequate information to apply the arm's length principle reliably. Taxpayers should be forthcoming with relevant information in their possession, and tax administrations should recognize that they can avail themselves of exchange of information articles in certain cases so that less need be asked of the taxpayer in the context of an examination...

The important aspects of this guidance can be summarised as follows:

- i) Taxpayers should make **reasonable efforts** at the time of the transfer pricing to prepare and maintain transfer pricing documentation – this is not saying that they need *provide* the information to tax authorities at the time, however – this ultimately depends on domestic law.
- ii) Tax administrations **should have the right to obtain taxpayers' documentation** prepared in the process of taxpayers' establishment of transfer pricing.
- iii) However, the governing principle for the transfer pricing documentation should be **"prudent business management" principles**. Therefore, a tax administration should have due regard for the extent to which that information reasonably could have been available to the taxpayer at the time transfer pricing was established.
- iv) A tax administration's **need for documents should be balanced by the costs** and administrative burdens of providing such documentation to a taxpayer
- v) Tax administrations and taxpayers should **try to cooperate with each other** for maintaining effective operation of the transfer pricing documentation regime.

- vi) Tax administrations should try to **rely on exchange of information provisions** of tax treaties to the extent possible, especially in relation to information not readily available to the taxpayer.

Of course it is recognised that most non-OECD countries do not have the extensive treaty networks of OECD countries and there will often have to be more reliance upon taxpayer provided information for this reason.

Under the OECD Guidelines, the following types of information among other things should be made available through documentation, although it is neither a minimum compliance list nor an exclusive list of information:

- Information about the **associated enterprises** involved in the controlled transactions and independent enterprises engaged in similar transactions;
- Information regarding the **nature and terms of the controlled transactions**, economic conditions and property involved in such transactions;
- Description of the circumstances of any known **transactions between the taxpayer and an unrelated party** that are similar to the transaction with the foreign associated enterprise, and therefore might be an arm's length comparison;
- Outline of the **business structure** of the organization, including the associated enterprises and ownership linkages within the MNE group;
- Information about the amount of **sales and operating results** of the associated enterprises from the last few years preceding the transaction; and
- Information on **pricing**, including business strategies and special circumstances that may be relevant, such as a "set-off" arrangement with the buyer providing the seller some services as part of the transaction.

Such information will help evaluate the **functions** performed by the associated enterprises, the **assets** used in doing this, and the **risks assumed** by the parties to the transaction, all of which will be important to a functional analysis of the type discussed in Chapter 7 of this Manual.

## **2. Documentation Rules of Pacific Association of Tax Administrators (2003)**

In 2003, the Pacific Association of Tax Administrators ("PATA"), which is comprised of tax administrations from Australia, Canada, Japan and the U.S., announced its "Transfer Pricing Documentation Package" (the "Package"). The Package<sup>2</sup> provides for a harmonized documentation procedure among PATA member states.

Taxpayers that choose to use the Package, which is voluntary, must meet the following three requirements in order to avoid penalties:

- i) Make reasonable efforts to establish arm's length prices;
- ii) Maintain contemporaneous documentation of their efforts to comply with the arm's length principles, and

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<sup>2</sup> Available at <http://www.irs.gov/businesses/international/article/0,,id=156266,00.html>

iii) Produce, in a timely manner, documentation upon request by a PATA member tax administrator.

The Package seeks to respond to the potential difficulties that MNEs face in complying with the laws and administrative requirements of multiple tax jurisdictions. It is intended to be consistent with the general documentation principles of the 1995 (and now 2010) OECD Guidelines.

In other words the Package is meant to give greater certainty to taxpayers, it has been criticised as doing so at the expense of minimising the documentation required. While the PATA guidelines state that the required documentation should not impose higher documentation requirements than those set forth in any PATA member's local laws, the Package has drawn criticism for the significant level of detailed requirements, which are perceived to be greater than those required by any particular member country – it essentially requires compliance with the domestic laws of all the PATA countries to ensure that a Penalty will not be applicable in one particular PATA jurisdiction.

The PATA guidelines should not therefore be seen as a template for other countries' documentation requirements; their greatest usefulness is perhaps that they form a compendium of local documentation requirements in the four PATA countries that may be a useful reference point for countries setting up a transfer pricing system.

The Package has been criticised in that it contains no guidance as to the nature of the comparable transactions (which would depend on the law of the PATA countries). In other words, no guidance is provided as to whether local comparables must be used, or whether some form of blended (foreign with local elements) comparable is required. As noted in Chapter 7 in Comparability, however, the reality is that for most developing countries, there will be no local comparables, and some form of adjustment to foreign comparables will often be necessary). As many developing countries do not have access to databases that allow identification of foreign comparables, and may have limited analytical resources to adjust those comparable for local conditions, it will be very important that the comparables relied on by taxpayer are well documented, with strong legal incentive (including strong penalty provisions to discourage provision of inaccurate information).

Further, the Package requires extensive documentation on organizational structure, nature of business (industry) and market conditions, controlled transactions, assumptions, strategies or policies, comparability, functional and risk analysis, selection and application of the transfer pricing method, details on cost contribution arrangements, background documents and an index to documents. The documents to be provided under the PATA Package are as follows:

*[The following table has been added by the Secretariat, and could alternatively be included as an annex, perhaps]*

<b>Organizational structure</b>	<ul style="list-style-type: none"><li>• Identification of the participants in the related party dealings and their relationship (with a brief history of and any significant changes in the relationship), including associated enterprises</li></ul>
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	<p>whose transactions directly or indirectly affect the pricing of the related party dealings</p> <ul style="list-style-type: none"> <li>• A description of taxpayer's worldwide organizational structure (including an organization chart) covering all associated enterprises engaged in transactions potentially relevant to determining an arm's length price for the documented transactions</li> </ul>
<p><b>Nature of the business/industry and market conditions</b></p>	<ul style="list-style-type: none"> <li>• An outline of the business including a relevant recent history of the taxpayer, the industries operated in, the general economic and legal issues affecting the business and industry, and the taxpayer's business lines</li> <li>• The corporate business plans to the extent they give an insight into the nature and purpose of the relevant transactions between the associated enterprises</li> <li>• A description of internal procedures and controls in place at the time of the related party dealings</li> <li>• Analysis of the economic and legal factors that affect the pricing of taxpayer's property and services</li> <li>• A description of the structure, intensity and dynamics of the relevant competitive environment(s)</li> <li>• A description of intangible property potentially relevant to the pricing of the taxpayer's property or services in the controlled transactions</li> <li>• Copies of annual reports and financial statements for the year to which the Package relates and the prior five years</li> <li>• Information as to the functions performed, assets employed and risks assumed relevant to the transactions</li> <li>• An explanation of capital relationships (e.g., balance and source of debt and equity funding) relevant to the transactions</li> </ul>
<p><b>Controlled transactions</b></p>	<ul style="list-style-type: none"> <li>• A description of the controlled transactions that identifies the property or services to which the transaction relates and any intangible rights or property attached thereto, the participants, the scope, timing, frequency of, type, and value of the controlled transactions (including all relevant related party dealings in relevant geographic markets), as well as the currency of the</li> </ul>

	<p>transactions, and the terms and conditions of the transactions and their relationship to the terms and conditions of each other transaction entered into between the participants</p> <ul style="list-style-type: none"> <li>• Identification of internal data relating to the controlled transactions</li> <li>• Copies of all relevant inter-company agreements</li> </ul>
<p><b>Assumptions, strategies, policies</b></p>	<ul style="list-style-type: none"> <li>• Relevant information regarding business strategies and special circumstances at issue, for example, set-off transactions, market share strategies, distribution channel selection and management strategies that influenced the determination of transfer prices</li> <li>• If the taxpayer pursues a market share strategy, documentation demonstrating that appropriate analysis was done prior to implementing the strategy, that the strategy is pursued only for a reasonable period, and that the costs borne by each associated enterprise are proportionate to projected benefits to such enterprise</li> <li>• Assumptions and information regarding factors that influenced the setting of prices or the establishment of any pricing policies for the taxpayer and the related party group as a whole</li> </ul>
<p><b>Cost contribution arrangements (CCA)<sup>3</sup></b></p>	<ul style="list-style-type: none"> <li>• A copy of the CCA agreement that is contemporaneous with its formation (and any revision) and any other agreements relating to the application of the CCA between the CCA participants</li> <li>• A list of the arrangement's participants, and any other associated enterprises that will benefit from the CCA</li> <li>• The extent of the use of CCA property by associated enterprises which are not CCA participants, including the amounts of consideration paid or payable by these non-participants for use of the CCA property</li> <li>• A description of the scope of the activities to be undertaken, including any intangible or class of intangibles in existence or</li> </ul>

<sup>3</sup> Where there is a CCA only, of course.

intended to be developed

- A description of each participant's interest in the results of the CCA activities
- The duration of the arrangement
- Procedures for and consequences of a participant entering or withdrawing from the agreement (i.e., buy-in and buy-out payments) and for the modification or termination of the agreement
- The total amount of contributions incurred pursuant to the arrangement
- The contributions borne by each participant and the form and value of each participant's initial contributions (including research) with a description of how the value of initial and ongoing contributions is determined and how accounting principles are applied
- A description of the method used to determine each participant's share of the contributions including projections used to estimate benefits, any rationale and assumptions underlying the projections, and an explanation of why that method was selected
- The consistent accounting method used to determine the contributions and benefits (including the method used to translate foreign currencies), and to the extent that the method materially differs from accounting principles accepted in the relevant PATA member's country, an explanation of the material differences
- Identification of each participant's expected benefits to be derived from the CCA, the extent of the benefits expected, and the formula and projections used for allocating or sharing the expected benefits, and the rationale and assumptions underlying the expected benefits
- Where material differences arise between projected benefits and actual benefits realized, the assumptions made to project future benefits need to be amended for future years, and the revised assumptions documented
- Procedures governing balancing payments, e.g. where

	<p>payments are required to reflect differences between projected benefits and actual benefits realized</p>
<p><b>Comparability, functional and risk analysis</b></p>	<ul style="list-style-type: none"> <li>• Description of the comparables including, for tangible property, its physical features, quality, availability; for services, the nature and extent of the services; and for intangible property, the form of the transaction, the type of intangible, the rights to use the intangible that are assigned, and the anticipated benefits from its use</li> <li>• Documentation to support material factors that could affect prices or profits in arm's length dealings</li> <li>• For the taxpayer and the comparable, identify the factors taken into account by the taxpayer to evaluate comparability, including the characteristics of the property or service transferred, the functions performed (and the significance of those functions in terms of their frequency, nature and value to the respective parties), the assets employed (taking into consideration their age, market value, location, etc.), the risks assumed (including risks such as market risk, financial risk, and credit risk), the terms and conditions of the contract, the business strategies pursued, the economic circumstances (for example, the geographic location, market size, competitive environment, availability of substitute goods and services, levels of supply and demand, nature and extent of government regulations, and costs of production, etc.), and any other special circumstances</li> <li>• Criteria used in the selection of comparables including database screens and economic considerations</li> <li>• Identification of any internal comparables</li> <li>• Adjustments (and reasons for those adjustments) made to the comparables</li> <li>• Aggregation analysis (grouping of transactions for comparability)</li> <li>• Supporting transfer pricing methodology or methodologies used, if any</li> <li>• If a range is used, documentation supporting the establishment of the range</li> </ul>



	<ul style="list-style-type: none"> <li>• Extension of the analysis over a number of years with reasons for the years chosen, where relevant</li> </ul>
<p><b>Selection of the transfer pricing method</b></p>	<ul style="list-style-type: none"> <li>• Description of the method selected and the reasons why it was selected, including, for example, economic analysis and projections relied upon</li> <li>• Description of the data and methods considered and the analysis performed to determine the transfer pricing and an explanation of why alternate methods considered were not selected</li> </ul>
<p><b>Application of the transfer pricing method</b></p>	<ul style="list-style-type: none"> <li>• Documentation of assumptions and judgments made in the course of determining an arm's length outcome (refer to the comparability, functional and risk analysis section above)</li> <li>• Documentation of all calculations made in applying the selected method, and of any adjustment factors, in respect of both the taxpayer and the comparable</li> <li>• Appropriate updates of prior year documentation relied upon in the current year to reflect adjustments for any material changes in the relevant facts and circumstances</li> </ul>
<p><b>Background documents</b></p>	<ul style="list-style-type: none"> <li>• Documents that provide the foundation for or otherwise support or were referred to in developing the transfer pricing analysis</li> </ul>
<p><b>Index to documents</b></p>	<ul style="list-style-type: none"> <li>• General index of documents and a description of the record-keeping system used for cataloging and assessing those documents (required in the United States and encouraged, but not required, by other PATA members). The general index is not required to be prepared contemporaneously.</li> </ul>

### 3. The European Union Code of Conduct on Transfer Pricing Documentation (2006)

In 2006, the Council of the European Council adopted a Code of Conduct on TP documentation for associated enterprises in the EU (the “Code”) in order to reduce the compliance costs of having to comply with different rules in each individual country. According to the Code,<sup>4</sup> taxpayers can avoid transfer pricing documentation penalties imposed by EU member countries if they maintain (i) a “master file” of standardized

<sup>4</sup> Available at <http://register.consilium.europa.eu/pdf/en/06/st09/st09738.en06.pdf>

information and (ii) a country-specific file of standardized information for each EU member country in which the taxpayer has related-party transactions.

Centralizing and standardizing documentation for centralized MNE groups is very likely to reduce their compliance burdens. The Code itself does not itself require contemporaneous documentation but, in practice, files should be prepared contemporaneously if a national law mandates contemporaneous documentation.

An EU Member State may decide not to require TP documentation at all or to require a shorter version of the EU transfer pricing documentation, i.e. require fewer items in the master file or the country specific documentation. However, a Member State should not require *more* items in the master file or the country specific documentation.

The Code also provides that translation to other languages would only be provided upon request and translation should not be required unless necessary in the circumstances. The Code seems particularly to deter countries from seeking translation of the Master File. The code also provides that EU member countries should not reject comparables found in pan-European databases automatically. Therefore, the use of non-domestic comparables by itself should not subject the taxpayer to penalties for non-compliance.

The “Master file” provides a “blue print” of the company and its transfer pricing system that would be relevant for all EU Member States concerned. The Master file should contain general descriptions of the group’s business strategy, organizational structure, general description of the controlled transactions involving associated enterprises in the EU, functions performed and risks assumed by enterprises, ownership of intangibles, group’s inter-company TP policy and a list of cost contribution agreements, APAs and TP rulings, etc.

The country specific documentation, on the other hand should contain a detailed description of the taxpayer’s business strategy, information on country specific controlled transactions, a comparability analysis, selection and application of the transfer pricing method, internal or external comparables, etc.

#### **4. Possible Lessons from the Existing International Guidelines of Transfer Pricing Documentation**

The International Guidelines above were designed by developed countries in the context of their own transfer pricing legislation, priorities and capabilities, and therefore cannot be automatically be assumed to be in every respect practical for developing countries. It is worthwhile in this respect to examine some of the issues these guidelines raise from the perspective of how they work in practice from a developing country perspective, bearing in mind the informational, analytical (including IT) and skills gaps that may exist between the tax administration and the MNE.

The essence of 1995 OECD TP Guidelines with regard to transfer pricing documentation can be described as follows:

- Taxpayers are required to prepare or obtain documents necessary to allow a reasonable assessment of whether they have complied with the arm’s length principle.

- In this context, a taxpayer's or tax authority's decision on the extensiveness of TP documentation should be balanced between the need for demonstrating taxpayer's compliance with the arm's length principle and additional costs to be incurred to prepare the required documentation.
- Therefore, taxpayers should not be expected to go to such lengths that compliance costs arising from the preparation of documentation are disproportionate to the amount of tax revenues at risk or to the complexity of the transactions.

Documentation rules of the PATA and EU's code of conduct on TP documentation have common features in that both were intended to respond to difficulties taxpayers faced in complying with the laws and administrative requirements of multiple tax jurisdictions. As a result, both provide taxpayers in their jurisdictions with a set of the documentation list respectively so that taxpayers can avoid penalties as long as they prepare and maintain documents included in those lists.

In order for such a list to be useful for taxpayers, it should not be so long and extensive as to inflict too much burden on taxpayers or unduly raise their compliance costs. At the same time, however, in order for such a list to be useful for tax authorities' reasonable assessment of a transfer pricing case, it should not be too superficial or limited to information that is already publically available. In short, a balance between the tax authorities' needs and taxpayers' costs should be maintained in determining the scope and the extent of the information to be included in a mandatory documentation list, whether it is a country list or an international list adopted by a group of countries. Especially, careful considerations for striking such a balance are necessary when a set of penalty rules, as an enforcement measures to the documentation rules, is designed.

### **III. Practical Guidance on Documentation Rules and Procedures**

#### **1. Burden of proof**

In most countries, the tax administration bears the burden of proof with respect to tax assessments unless a tax law specifically provides otherwise. It means that, in general situations, taxpayers need not prove the correctness of their transfer pricing or transactional margin unless the tax administration challenges taxpayers with concrete and clear grounds for such challenges.

However, if one country has a set of specific documentation rules in its tax law or regulations, it is generally understood that the burden of proof for the transfer price at which a taxpayer transfers good or services with his/her related parties falls on the taxpayer unless the taxpayer is believed to have fulfilled the obligations imposed by such documentation rules. Even where the burden of proof rests on the tax administration, the tax administration might still require the taxpayer to provide documentation about its transfer pricing, because without adequate documentation, the tax administration cannot assess the case properly. In fact, where the taxpayer does not provide adequate documentation, there may be a shifting of burden of proof in some countries in the manner of a rebuttable presumption in favor of the adjustment proposed by the tax administration.

In most countries where the burden of proof rests generally on the taxpayer, the burden of proof shifts to the tax administration if a taxpayer presents to the tax administration (or a court) a reasonable argument and evidence to suggest that the transfer pricing was at arm's length. Especially, in countries where taxpayers generally bear the burden of proof but the specific documentation rules are already in place, the tax administration generally bears the burden of proof if a taxpayer has fulfilled reasonable level of obligations required by such documentation rules.

It is therefore important that the documentation rules are broad enough to give a true picture of the related party transaction, without being excessively burdensome on the chance, though unlikely, that a particular piece of information may be relevant.

More importantly, however, the burden of proof should not be misused by the tax administration or taxpayers as justification for making assertions about transfer pricing, which may be very difficult to substantiate through an ordinary level of TP documentation. In other words, both the tax administration and the taxpayer should make a good faith showing through reasonable documentation that their determinations on transfer pricing are consistent with the arm's length principle regardless of where the burden of proof lies.

*[Examples of the Burden of Proof in developing countries and how it relates to developing countries would be useful here – Secretariat Note]*

#### **2. Timeframe to produce TP documentation**

In general, countries have different types of documentation *timing* requirements, involving one or more of the following requirements:

- Prepare information at the time of the transactions, to be submitted at the time of the filing;
- Prepare information at the time of the transactions, to be submitted upon request in case of an audit;
- Prepare information at the time of the filing;
- Prepare information only if requested upon audit; or
- No documentation requirement.

As paragraphs 3.69-3.71 of the 2010 OECD TP Guidelines state, taxpayers, in some cases, establish transfer pricing documentation to demonstrate that they have made reasonable efforts to comply with the arm's length principle at the time their intra-group transactions were undertaken (hereinafter "the arm's length price-setting" approach), based on information that was reasonably available to them at that point. Such information includes not only information on comparable transactions from previous years, but also information on economic and market changes that may have occurred between those previous years and the year of the controlled transaction. In other instances, taxpayers might test the actual outcome of their controlled transactions to demonstrate that the conditions of these transactions were consistent with the arm's length principle (hereinafter "the arm's length outcome-testing" approach). Such test typically takes place as part of the process for establishing the tax return at the end of a tax year.

A country that wishes to establish a TP documentation rule, especially so-called "contemporaneous documentation requirements" in its TP regime, should take into account that there exist the two pricing approaches mentioned in the previous paragraph and that, when a taxpayer opts for the arm's length *outcome-testing* approach, data for external comparables are often not readily available by the year-end or by the due date of the tax return filing.

Perhaps for this reason, and because the tax authorities will not be seeking such documentation at the time of the transfer pricing, the OECD TP Guidelines do not require contemporaneous *presentation* of documentation to the tax authorities, or that they be fully ready to present to the documents at that time (Paragraph 5.4). The document storage process is therefore left to the taxpayer's discretion under the Guidelines.

*[Ultimately the storage issue may depend on domestic law – do countries require the taxpayer to store the material in a [readily searchable] electronic format, rather than, for example the taxpayer be allowed to keep only paper formats? – Secretariat Note]*

Further, the Guidelines provide some guidance on the amount of information to be submitted to tax administration at the time of tax return filing. Paragraph 5.15 of Guidelines recommends limiting the amount of information requested by tax administration at the stage of tax return filing.

The basis for this is that at the time of filing, no particular transaction has been identified for transfer pricing review and that all that is needed at that stage is enough information to know if a further examination is needed of particular taxpayers.

The guidelines note that it would be quite burdensome if detailed documentation were required at this stage on all cross-border transactions between associated enterprises, and by all enterprises engaging in such transactions. Therefore, it would be unreasonable to require the taxpayer to submit documents with the tax return specifically demonstrating the appropriateness of all transfer price determinations.

In practice, most countries *either* do not require the submission of transfer pricing related information at all *or* require only a minimum level of information at the tax return filing stage.

The **PATA Documentation Package** noted above indirectly encourages contemporaneous documentation by establishing a rule that a taxpayer that voluntarily uses the PATA Documentation Package must maintain contemporaneous documentation if they wish to avoid penalties. A number of countries have adopted provisions in their tax legislation similar to those of the PATA Package, providing that the tax administration cannot impose any penalty if a taxpayer complies with documentation obligation contemporaneously – adjustments can still be made and interest charged on those adjustments, of course.

The **EU Code of Conduct** itself does not require contemporaneous documentation but, in practice, files should be prepared contemporaneously if a relevant national law requires contemporaneous documentation.

*[More on developing country practice would be useful here – Secretariat Note]*

### **3. Penalties**

Penalties can be generally divided into two groups based on the reason for imposing them: for underpayment of tax that is due and for non-compliance with documentation requirements. Penalty rules are often used to ensure taxpayer compliance with transfer pricing documentation requirements.

However, a number of countries also have incentive measures of exempting penalties against underpayment of taxes in cases where obligations for proper documentation (frequently contemporaneous documentation) have been fulfilled by taxpayers even in cases where the amount of taxable income turns out to be increased as a result of a tax audit. The principle governing this incentive measures is often called “no-fault, no-penalty principle”.

In general, penalties can entail civil (or administrative) or criminal sanctions. Penalties imposed for failure to meet TP documentation requirements are usually monetary sanctions with a civil or administrative, rather than a criminal, nature. More closely scrutinized tax audit or discretionary application of TP methods by tax authorities using a secret comparable or so-called “deemed income,” which is calculated using a formula stipulated in the tax law, are sometimes seen as a type of penalty for noncompliance with TP documentation rules, although they can equally be seen as resulting in the greater risks of non-compliance in such cases.

It would be unfair to impose sizable penalties on taxpayers that exerted reasonable efforts in good faith to undertake a sound transfer analysis to ascertain the arm's length pricing, even if, despite this, they ultimately did not fully satisfy TP documentation requirements. In particular, it seems too harsh to impose penalties on taxpayers for failing to submit data to which they did not have access, or for failure to apply a transfer pricing method that would have required the use of data unavailable to the taxpayer. Once again, this does not mean an adjustment cannot be made in such cases, with interest accruing on that amount,

Some countries consider that a penalty imposed as a consequence of lack of proper TP documentation can be dealt with in the mutual agreement procedures between competent authorities because it is covered by the taxes to which a relevant tax treaty applies. Others consider that the issue of penalties, especially in relation to documentation, is distinct from the adjustments it has made and also from the issue of whether it has taxed in accordance with the relevant tax treaty.

However, even where such a penalty is not covered by a tax treaty's mutual agreement procedure procedure, the penalty should not be applied in a manner that would severely discourage or invalidate a taxpayers' reasonable reliance on the benefits of the tax treaty, including the right to initiate the mutual agreement procedure as provided in the relevant tax treaty.

For example, a country's requirements concerning the payment of an outstanding penalty should not be more onerous to taxpayers in the context of the mutual agreement procedure than they would be in the context of a domestic law review initiated by the taxpayer.

#### **4. Special considerations for small and medium-sized enterprises (SMEs)**

Comprehensive documentation requirements and subsequent penalties imposed on non-compliant taxpayers in a country may cause significant burdens on taxpayers, especially on SME taxpayers who engage in cross-border transactions with overseas related parties. Considering that a taxpayer should not be expected to incur disproportionately high costs and burdens to obtain documents from foreign associated enterprises, a number of countries have introduced certain special considerations in their TP documentation rules, based on which SME taxpayers or taxpayers without heavy involvement in international transactions can be exempted from the TP documentation requirements.

The following countries have been selected as samples to demonstrate special considerations for TP documentation in the case of SMEs<sup>5</sup>:

#### **France**

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<sup>5</sup> The following examples of practice are largely quoted from a transfer pricing documentation survey conducted by Salans Vox Tax in 2009. Refer to [www.salans.com](http://www.salans.com). However, for China, please refer to the periodical of Beijing, Hong Kong, Shanghai offices in Baker & McKenzie ("Transfer Pricing", January 2009). For Korea, please refer to materials from the website of National Tax Service in Korea ([www.nts.go.kr/eng/data/KOREANTAXATION2010.pdf](http://www.nts.go.kr/eng/data/KOREANTAXATION2010.pdf)).

France has issued guidance for SMEs, with the effect that the mandatory TP documentation requirements in the legislative proposal will only apply to large enterprises. Thus, SMEs should only undertake TP documentation upon a specific request of the French tax authorities (FTA) in the course of a tax audit. In principle, such requests may occur only under exceptional circumstances if the FTA has gathered sufficient evidence suggesting a transfer of profit to related foreign entities. However, small companies are also encouraged to prepare contemporary TP documentation.

### **Germany**

SMEs do not have a duty to issue TP documentation. However, they are obliged to provide further information and documents about the foreign business transactions when requested by tax authorities. In this case, issuance of TP documentation less detailed than that required for larger companies is provided for.

### **Netherlands**

There are no specific rules applicable to SMEs; all enterprises are obliged to prepare and keep TP documentation. However, in practice, the TP documentation obligation is applied in a flexible manner; small companies are often permitted to provide less detailed TP documentation as compared to large companies.

### **Poland**

Enterprise size does not have an influence on TP documentation requirements. However, the volume of the transactions does: the TP documentation refers only to transactions where the annual turnover in a given tax year exceeds the equivalent of:

- EUR 100,000<sup>6</sup> – if the value of the transaction does not exceed 20% of the share capital of the company;
- EUR 30,000 – in the case of rendering services or sale of intangible values;
- EUR 50,000- in all other cases; or
- EUR 20,000 – for all payments made to tax havens.

### **Spain**

There could be several types of documentation compliance burdens depending on the characteristics of the parties involved. Relevant factors include a turnover of EUR 8 million or more, which may trigger a requirement to provide further and more thorough information. Another factor is whether transactions are undertaken with entities or individuals based in secrecy jurisdictions.

### **China**

There are three kinds of enterprises that are exempt from contemporaneous documentation obligation:

- Entities with annual related party sales and purchase of less than 200 million RMB<sup>7</sup> and other related party transactions of less than 40 million RMB;

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<sup>6</sup> A Euro was worth approximately 1.4 USD as of May 2011.



- Entities within the coverage period of an APA; or
- Entities with less than 50% foreign invested shares that only have transactions with domestic related parties.

### **Korea**

The method used and the reason for adopting that particular one for an arm's length principle determination must be disclosed to the tax authorities by a taxpayer in a report submitted along with the annual tax return. This is not the case, however, if the total value of cross-border transactions of goods and that of cross-border transactions of services of the taxpayer for the taxable year concerned is Korean Won (KRW<sup>8</sup>) 5 billion or less and KRW 500 million or less, respectively. The above obligation is also exempt for the taxpayer whose inter-company transaction volume per an overseas related party is KRW 1 billion or less for goods and KRW 100 million or less for services.

In summary, some countries have particular legislative provisions that allow exemptions from the obligation for TP documentation or submission of documents to tax authorities at the time of filing tax returns. However, some countries allow similar exceptions by an administrative measure notwithstanding the lack of any specific legislation granting such exceptions. In some countries, exemptions or mitigation of TP documentation obligation are targeted to SMEs directly. However, a number of countries operate such exemption or mitigation regime mainly targeting taxpayers whose transaction volumes with overseas related parties are quite limited. Since most SMEs are in general not heavily involved in cross-border transactions with overseas related parties, they often enjoy benefits of these exemptions in an indirect way.

## **5. The language to be used for TP documentation**

The guidance provided by the EU Code of Conduct on TP documentation regarding the language issue may be very useful for a country that wishes to establish its own TP documentation rule. As one of the basic principles to be applied to the EU Transfer Pricing Documentation, the Code adopts in Paragraph 6 that the country-specific documentation should be prepared in a language prescribed by the Member State concerned, even if the MNE has opted to keep the country-specific documentation in the "master file".

However, in Paragraph 23 prescribing the general application rules and requirements for Member States, the Code states that it may not always be necessary for documents to be translated into a local language and that, in order to minimize costs and delays caused by translation, Member States should accept documents in a foreign language to the greatest extent possible. Further, the Code recommends that, as far as the EU Transfer Pricing Documentation is concerned, tax administrations be prepared to accept the master file in a

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<sup>7</sup> 6.5RMB were worth approximately 1USD as of May 2011.

<sup>8</sup> 1000 KRW were worth approximately 1USD as of May 2011.

commonly understood language in the Member States concerned and that translations of the master file be made available only if strictly necessary and upon specific request.

According to a country survey,<sup>9</sup> most countries require taxpayers to present TP documentation in their own languages and require translation if the TP documentation was prepared in a different language. However, some countries such as France, Germany, Netherlands and Korea allow present TP documentation in a language other than their own languages as least on an exceptional basis. It is particularly common in practice to allow documentation to be provided in English.

The recent Egyptian TP guidelines<sup>10</sup> provide that if documents are provided other than in Arabic, the taxpayer may be required to bear the cost of an official translation.

*[It would be useful to have more developing country examples here – Secretariat Note]*

*[Perhaps there should be a distinct heading on whether copies need to (i) be provided in electronic form, and whether (ii) they should be required to be as readily searchable as the electronic copies held by the enterprise, i.e. in readable pdf form rather than scanned without optical character recognition, although the level of detail in (ii) may be unnecessary – Secretariat Note]*

*[On a related point, one of the characteristics of TP documentation is its size and complexity – perhaps some guidance can be given on general document handling, tracking, evidential, searching and access issues for large TP “files” – i.e. document management for large and complex files.- Secretariat Note]*

## **6. Information to be included in the TP documentation**

In preparing TP documentation, MNEs must decide the type and scope of documentation and information that should be provided to tax authorities to meet various documentation requirements and avoid any tax adjustments and penalties, while at the same time minimizing added burdens and potential tax exposure in the event of a tax controversy.

The main objective of preparing and maintaining documentation is to place the taxpayer in a position where it can readily demonstrate that it has exerted reasonable efforts to ensure that its transfer prices are consistent with the arm’s length principle. As indicated in the previous sections, international TP documentation guidelines of OECD, PATA and the EU contain rather detailed TP documentation lists, respectively. Likewise, a number of countries have mandatory or illustrative lists of TP documentation in their tax laws or regulations.

However, it would not be possible to specify a comprehensive list of documentation requirements that would meet the needs of all taxpayers or tax administrations because the

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<sup>9</sup> Refer to the survey conducted by Salans Vox Tax in 2009.

<sup>10</sup> Available at <http://www.us.kpmg.com/microsite/taxnewsflash/tp/2011/English%20Final.pdf>

documentation required depends on the specific facts and circumstances of each case and the TP regime applicable in a country. Nevertheless, it would be useful to check common items or features that are included in TP documentation. An example of this can be found in “a Sample of TP Study” included in Annex 2 to this Chapter, which was prepared by a business grouping, the international Chamber of Commerce.

First of all, information as to the related parties that are involved in the controlled transactions at issue needs to be documented. Such information includes *i)* an outline of business with transaction parties, *ii)* the structure of the organization, *iii)* ownership linkage within the MNE group, *iv)* the amount of sales and operation outcome from the last few years preceding the transaction; *v)* the level of the taxpayer’s transactions with foreign related parties, for example the amount of inventory sales, value of services rendered, rent for tangible assets, the use and transfer of intangible property, and interest on loans, etc.. Information about functions performed, assets used and risks assumed would be important items for TP documentation.

The current business environment and forecasted changes or commercial and industry conditions affecting the taxpayer, such as market scale, competitive conditions, regulatory framework, technological progress, foreign exchange market, also may need to be documented.

An explanation of the selection, application, and consistency with the arm’s length principle of the transfer pricing method used for the establishment of the transfer pricing is also needed. Information on factors influencing the setting of prices or the establishment of any pricing policies for the taxpayer and the whole MNE group would be also useful.

If the documentation is designed to allow the evaluation of comparables used in a transfer pricing study, it would not be sufficient merely to provide a list of “comparables.” In cases where internal or third-party comparables are used by a taxpayer to support its transfer pricing policy, supporting documentation should be provided explaining the process followed to arrive at a particular list of comparables and the arm’s length range of those comparables. Comparables are dealt with in detail in Chapter 7 of this Manual.

The 2010 OECD TP Guidelines contain a description of a typical process used to identify comparable transactions and utilize the data so obtained through comparability analysis. Where a transfer pricing study relies on comparable information which has been obtained following such a process, it would be reasonable to expect each of the steps to be documented in order to make it possible for the tax administration conducting an audit to assess the quality of the analysis.

For example, if a taxpayer uses multiple-year data on the ground that its transactions are affected by business cycles, it would be reasonable for the taxpayer to provide some documentation explaining why a business cycle is a factor to be considered, the type (e.g., business cycle, product cycle) and duration of the cycle and placement of the controlled enterprise in the cycle. Based on this analysis, the qualitative and quantitative criteria used to select or reject comparables should be carefully documented.

Where a taxpayer concludes that no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amount at issue, reasons for such conclusion should be duly explained together with supporting documentation.

Special circumstances would include details concerning any intentional set-off transactions that have an effect on determining the arm's length price. In such a case, documentation may be necessary to help describe the relevant facts, the qualitative connection between the transactions, and the quantification of the set-off arrangement. In this situation, contemporaneous documentation helps minimize the use of hindsight, and the possible suggestion of manipulation based on that hindsight.

TP documentation for intra-group services is vitally important to allow tax authorities to satisfy themselves as to the legitimacy of intra-group service charges, including management fees. When TP documentation is prepared for intra-group services, it should be focused on whether intra-group services have in fact been provided and what the intra-group charge should be for such services for tax purposes. Once the relevant intra-group services have been identified, the documentation of such intra-group services performed by the service provider and the benefits received by the service recipient should be thoroughly prepared.

A cost contribution arrangement (CCA) is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights. The documentation is crucial for the proper operation of a CCA but also for proper tax treatment of a CCA, because the form and value of each participant's contribution cannot be properly obtained without proper documentation. The prudent business management principles espoused in the OECD Guidelines would lead the participants to a CCA to prepare or obtain materials regarding the nature of the subject activity, the terms of the arrangement, and its consistency with the arm's length principle.

Over the duration of the CCA's term, the following information could be particularly useful:

- Terms, participants, subject activity and conditions of initial arrangements and any change to the arrangement;
- The manner in which participants' proportionate shares of expected benefits are measured, and any projections used in this determination;
- The form and value of each participant's initial contributions, and a detailed description of how the value of initial and ongoing contribution is determined;
- Any provisions for balancing payments or for adjusting the terms of the arrangements to reflect changes in economic circumstances;
- A comparison between projections used to determine expected benefits from CCA activity with the actual results; and
- The annual expenditure incurred in conducting the CCA activity, the form and value of each participant's contributions made during the CCA's terms, and a detailed

description of how the value of contributions is determined and how accounting principles are applied consistently to all participants.

## Annex 1: Examples of Country Rules on Documentation

### 1. Korea<sup>11</sup>

#### A. Reporting of the method of determining an arm's length price to the tax authorities

- A taxpayer should select the most reasonable method of determining an arm's length price in accordance with the criteria provided in the legislation and report the selected method and the reason for the selection to the district tax office at the time of filing a tax return.
- When filing the tax return, the taxpayer entering into an international transaction with a related party overseas should submit to the district tax office a detailed statement of the international transaction specified in the Ministerial decree (Form No.8) together with the simplified profit and loss statements or financial statements of the overseas related party.
- This is not the case, however, if the total value of international transactions of goods and that of international transactions of services of the taxpayer for the taxable year concerned is 5 billion Korean Won or less and 500 million Korean Won or less, respectively.

#### B. Taxpayers' obligation to submit the requested information on international transactions

- The tax authorities may request a taxpayer to submit the relevant information necessary for applying the transfer pricing rules including the TP method used for determining the transaction price in question.
- The information to be requested includes the following:
- Various contracts regarding the transfer or purchase of properties;
  1. Price list of the products;
  2. Details of manufacturing costs of the products;
  3. Details of transactions made with related and unrelated parties for each line of products;
  4. In the case of the supply of services or other transaction, the documents similar to those listed above;
  5. Organization chart and job description of the concerned corporations;
  6. Data used for the determination of international transaction prices;
  7. Price determination policy between and among related parties;
  8. Accounting standards and methods related to the transactions in question;
  9. Details of business activities performed by the parties connected to the transaction in question;

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<sup>11</sup> TP documentation is provided in the Law for Coordination of International Tax Affairs (LCITA) and its Enforcement Decrees.

10. Ownership relations among the related parties;
11. Forms or items not submitted to the district tax office in filing tax return;
12. Other data necessary for computing an arm's length price.

- The above data must be prepared and submitted in Korean. However, they can be prepared and submitted in English if tax authorities permit it.
- A taxpayer who is requested to submit information should submit such information within 60 days of the date the request is received. However, if the taxpayer files an application for an extension of the due date with a justifiable reason as prescribed by the Enforcement Decree, the tax authorities may allow an extension for up to 60 days.

### **C. Sanctions against the noncompliance with the request for submission of information**

- If a taxpayer who is requested to submit information fails to submit the requested information by the due date without a justifiable reason, and instead submits the information at a later stage where filing a tax appeal or in the course of a mutual agreement procedure provided in a tax treaty, the tax authority or other related authorities may decide not to use such documents as evidence for taxation purposes.
- If a taxpayer who is requested to submit information fails to submit the requested information by the due date without a justifiable reason, the taxpayer shall be subject to a fine for negligence up to an amount of 100 million Won (approximately USD100,000).

### **D. Exemption from under-reporting penalty in case of contemporaneous documentation**

- Tax authorities should not impose a penalty for the under-reporting of income (10% of the additional tax amount due) if it confirmed through competent authorities' mutual agreement procedures that the taxpayer did not commit a fault with regard to the difference between the reported transaction price and the arm's length price. It shall not be deemed that the taxpayer was at fault if the following conditions are met:
  1. The taxpayer presents the procedure through which the most reasonable method was selected out of the methods of determining an arm's length price with documentation prepared at the time of filing tax return;
  2. The taxpayer actually used the selected method;
  3. The taxpayer has kept necessary data and information related to the selected method.
- Tax authorities should not impose a penalty for the under-reporting of income (10% of the additional tax amount due) if a taxpayer has prepared and maintained contemporaneous TP documentation for the TP methods applied to the cross-border intercompany transactions reported in the corporate income tax return, and such documentation substantiates the reasonableness of the selected TP methods and the application thereof. A taxpayer shall prepare and maintain the following documentation at the time of reporting corporate or income tax and submit it within 30 days upon request by the concerned tax authorities:
  1. Outline of the business (including an analysis of factors influencing prices of its assets and services)



2. Business organizational chart (illustrating related parties to which TP may be applicable)
  3. Documents illustrating the process by which the applied TP method was selected:
    - i. Economic analysis and projections that served as the basis for selecting the particular TP method;
    - ii. Documents describing the details of adjustments made in determining the arm's length price range using comparables' data;
    - iii. Alternative TP methods and the reasons for which those were not selected;
    - iv. Relevant documents concerning the time period from the end of the taxable period until the filing of the tax returns.
- Criteria applied in determining the above-mentioned "reasonableness" are as follows
1. With the end of the concerned taxable period as the basis, whether the collected data on the comparables are adequately representative. Particularly, it should be examined whether an omission of data of a certain comparable led to an outcome advantageous to the taxpayer;
  2. Whether the selection and application of the concerned TP method is supported by systematic analysis of the collected data.
  3. If a certain TP method was agreed upon through an APA process in a prior taxable year or was selected by the tax authorities during an audit, whether there are reasonable grounds for applying or not applying the said TP method for the concerned taxable year.

## **2. India**

### **A. Documentation to be Maintained**

- Sec. 92D of the Finance Act read with Rule 10D(1) of the Income Tax (IT) Rules lays down thirteen different types of information / documents that a person, entering into international transactions with associated enterprise(s), is required to maintain. Broadly, these information / documents can be classified as:
  - Enterprise-wise documents;
  - Transaction-specific documents; and
  - Computation related documents.

### **B. Enterprise-wise documents**

- These documents describe the enterprise, the relationship with other associated enterprises, nature of business carried out, etc. This information is largely descriptive [Clauses (a) to (c) of Rule 10D(1) of the IT Rules]. An illustrative list of information / documents to be maintained under this classification is provided below.
  - Ownership / shareholding pattern of the taxpayer;
  - Business profile of the multinational group;
  - Details of associated enterprise(s) with whom international transactions are entered into;
  - Business of the taxpayer and the associated enterprise(s); and
  - Broad industry profile in which the taxpayer operates.
- The above documentation would provide the tax authorities with the preliminary information of the taxpayer's group profile, function in the group and the industry in which it operates. The broad industry profile, if well documented, will provide the tax authorities with an overview of the demand and the business drivers within the industry as well as the taxpayer's position in the industry. The documentation can also provide an overview of the taxpayer's growth objectives, given the evaluation of the industry sector and the competitive dynamics within industry in which the taxpayer operates.

### **C. Transaction-specific documents**

- These documents explain each international transaction in detail e.g. the nature and terms of contracts, description of the functions performed, assets employed and risks assumed by each party to the transaction, economic and market analyses, etc. [Clauses (d) to (h) of

Rule 10D(1) of the IT Rules]. An illustrative list of information/ documents to be maintained under this classification is provided below.

- Details of each international transaction e.g. name of the associated enterprise, product transferred / service provided, quantity, price; shipment and credit terms, etc.;
  - Functional analysis of the taxpayer and associated enterprise(s) listing the functions performed, assets employed and risks assumed for undertaking the international transaction;
  - Pricing policy adopted for the international transaction;
  - Budget / forecasts for the taxpayer's business;
  - Reports of market research studies carried out and technical publications brought out by institutions of national or international repute;
  - Record of uncontrolled transactions (internal and external comparables) for each international transaction including nature and terms of the uncontrolled transactions; and
  - Economic analysis to provide details of data used and data rejected with reasons thereof.
- The above information would capture the relevant information about the taxpayer and the concerned associated enterprise(s). The documentation of the precise functions performed by the parties (taxpayer and associated enterprise) and the economic characterisation (e.g.: integrated manufacturer, contract manufacturer, indenting agent, support service provider, etc) of the respective parties would be relevant here. The economic characterisation of parties would assist the taxpayer to determine the tested party. The tested party concept has been discussed in Chapter 7.
- In case the foreign associated enterprise is considered as the tested party for a particular international transaction, the relevant documents regarding the foreign associated enterprise should be maintained. The Income Tax Appellate Tribunal in the case of Ranbaxy Laboratories Ltd. observed that if taxpayer wishes to take a foreign associated enterprise as the tested party it must ensure that the relevant data for comparison is available in public domain or is furnished to tax administration. Chapter [\_\_\_] discusses that decision in more detail.

#### **D. Computation related documents**

- These documents detail the methods considered, actual working assumptions, adjustments made to the transfer prices and any other relevant information / data relied for determining the ALP [**Clauses (i) to (m) of Rule 10D(1) of the IT Rules**].
- An illustrative list of information / documents to be maintained under this classification is provided below.
  - Nature of each international transaction and the rationale for selecting the most appropriate method for each international transaction. The taxpayer is required to substantiate the selection by proper documentation and the manner in which the method was applied to each international transaction;
  - Actual working / computation of the arm length's price i.e. recording the calculations i.e. comparability analysis performed to determine whether or not uncontrolled transactions are comparable to the international transactions with reasons for adjustments made to make the comparability analysis more reliable.
  - Critical factors and assumptions influencing the determination of the ALP;
  - Adjustments made (along with reasons) to the taxpayer's transfer prices so as to align it with ALPs; and
  - Any other information relevant for the determination of the ALP

-One of the aspects of documentation is to capture the group policies and the pricing methodology of the international transaction. For instance, pricing methodology could be either on cost plus mark-up basis, percentage on sales basis, bilateral negotiations basis, etc to appropriately substantiate the arms length nature of the transaction.

#### **E. Contemporaneous documentation**

- Rule 10D(4) of the IT Rules require that the information and documents maintained by an taxpayer to demonstrate that the transaction price meets with the arm's length principle should be contemporaneous to the extent possible and should exist latest by the due date for filing the return of income.
- A question that arises is what is meant by contemporaneous documentation. The Oxford Dictionary defines the term 'contemporaneous' as '*Existing or occurring in the same period of time*'. Possibly, the contemporaneous documentation can be the one that -
  - exists or brought into existence at the time (by the due date for filing the return of income) the taxpayer is developing or implementing any arrangement that might raise transfer pricing issues; and

- records all relevant information that was necessary for the management to make transfer pricing decisions. The documentation may be electronic or in written form, which includes books, records, contracts, studies, periodic activity reports, budgets, plans, projections, analysis, conclusion and other material.
- Further, contemporaneous documentation maintained could have the following characteristics:
  - Completeness;
  - Accuracy i.e. true and proper information; and
  - Timeliness - information is maintained as and when the international transactions take place. This may not always be possible to comply with, e.g., when subsequent benchmarking under the TNMM alone would show whether or not the international transactions have been carried out at prices which have yielded an arm's length margin.
- Transfer pricing documentation is generated at various stages. For example, there could be the documentation which is maintained by a taxpayer as part of its ordinary business operations and used by it to set the prices (e.g. in case of cost plus based pricing, definition of 'costs') of its international dealings with associated enterprise(s) (e.g. invoices, orders, etc.). Another form of documentation could be the one which is maintained by the taxpayer for establishing whether such prices comply with the arm's length principle.
- The TPR do not clearly provide what is the nature of documentation to be maintained for each international transaction. Further, the TPR do not distinguish between the different nature of transactions for the purpose of maintaining documentation i.e. the normal transactions and the transactions in exceptional circumstances e.g. market penetration, distress sale, pricing strategy, etc. In such cases, the taxpayer should endeavour, as far as possible, to record all relevant information (available at the time of entering into the international transaction) that is critical for the management to determine the pricing / other factors of the international transaction. The information / documents maintained could be in the form of minutes of Board of Directors meeting, emails, faxes, agreements, quotations, independent valuations, market surveys, etc.
- The ensuing paragraphs illustrate the documentation to be maintained while entering into certain exceptional transactions like market penetration and distress sale. However,

specific information and documentation may vary in each case depending on the type of business and size of business operations of the enterprise.

**F Documenting market penetration strategies**

- Market penetration is a business strategy adopted which involves reduction in current profits in anticipation of an increase in future profits. The key element here is to analyse whether a third party would be prepared to trade off its current profits in expectation of increased future profits under same / similar conditions.
- Hence, if a taxpayer intends to implement such a strategy, it is imperative, on its part to document all the key facts / circumstances under which such a strategy is implemented and how the implementation of such a strategy meets with the arm's length principle. Documents for this purpose could be market feasibility report, document highlighting broad outline of the strategy, benefits sought to be achieved, future profitability outcome/budgets that would demonstrate assumptions for adopting this strategy, etc.

**G Documenting "distress sales"**

- A distress sale is a forced sale of an asset / investment at significantly reduced price because of certain necessity / crisis.
- To illustrate, a project office which is abruptly closing down sells its assets to group companies. In cases of distress sale, the documentation for such a transaction should demonstrate the rationale behind a distress sale and the justification on how the said international transaction meets with the arm's length principle. Documents for this purpose could be minutes of the board, shareholders meeting, Government approval, market survey reports or asset valuation reports, etc.

**H. Documenting receipt of intra-group services**

- An intra-group service is a service performed by one member of a multi-national group for the benefit of one or more members of the group. The services offered / performed can be of administrative, technical, financial or commercial nature and may include management, co-ordination and control functions for the entire group. The key element here is to analyse the arm's length nature of intra-group services would be whether an independent enterprise (service recipient) in similar circumstances would have been willing to pay for or itself perform such services.
- The documentation for such a transaction (from a service recipient perspective) should demonstrate actual receipt of services and the benefits derived therefrom. The benefits received may be quantified to the extent possible. Documentation for this purpose could

be minutes of meeting / telephone calls, detailed description of the benefits received demonstrated by way of correspondences, memoranda, manuals, etc. Further, a certificate from an independent accountant of the service providing entity may be obtained certifying the method of allocation of costs and authenticity of the cost apportioned to each entity. It may also be beneficial to document that the services could not have been rendered internally (by the service recipient) or by third parties.

**I. Documenting reimbursement / recovery of expenses**

- In certain circumstances one of the associated enterprises (Company ‘X’) incurs routine expenditure (e.g.: travel, hotel, freight, courier charges etc.) on behalf of another associated enterprise (Company ‘Y’). The primary liability to incur the expenditure and make payments to the concerned third party vendors is that of Company Y and it is purely for administrative convenience that the said payment is made by Company X and subsequently recovered from Company Y (without any mark-up).
- The parties to the transaction should maintain internal documentation like internal memos, email correspondences, etc. to demonstrate that the expenses were disbursed by Company X on behalf of Company Y and that all such expenses has been duly recovered.
- The invoices raised by the third party vendors on Company X would form part of the documentation to substantiate that Company X has recovered the entire amount (at cost) from Company Y.
- To the extent possible, one should attempt to maintain transfer pricing documentation at the time of entering into the international transaction. Further, in any case, the same should exist latest by the due date for filing the Return of Income.

**J. Need for Fresh Documentation**

- A proviso to Rule 10D(4) of the IT Rules require that if an international transaction continues to have effect over more than one previous year, fresh documentation need not be maintained separately in respect of each year, unless there is any significant change in the following:
  - Nature or terms of the international transaction; or
  - Assumptions made; or
  - Any other factor which would influence the transfer price.
- However, if there has been a significant change in any of the above, fresh documentation (as may be necessary) should be maintained bringing out the impact of the above change on the pricing of the international transaction.
- It is therefore important for each taxpayer to scrutinize, on yearly basis, whether any fresh documentation is required to be maintained for any continuing transaction.





## Sample Documentation Package

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Please note that annexes 1, 2, 6, 7 and 9 are not included in the sample documentation package, as they are specific to each company.



## I. OECD Transfer Pricing Requirements

### A) Purpose of the Report

This report compiles the transfer pricing documentation in support of the related party transactions between Parent Company and its subsidiaries (collectively the “Company”) for the taxable year ended 31 December 20XX. This report was prepared with respect to the application of the arm’s length principle pursuant to the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published by the Organisation for Economic Cooperation and Development (the OECD Guidelines).

### B) Business Description

#### 1. General Corporate Background

The Company was incorporated on 1 January 19XX in country. It is publicly traded on the exchange. The Company is a leading provider of products and services. It offers its products and services through four business segments: Segment #1, Segment #2, Segment #3 and Segment #4. Attached hereto as Annex 1 is a copy of the Company’s Annual Report/Public Security Market Disclosure Reports which provides additional information about the Company’s business.

An organizational chart for the Company and its subsidiaries is attached hereto as Annex 2. The Company has a network of offices extending across more than 50 countries and had more than 50,000 employees by the end of 20XX.

#### 2. General Business Activity

Brief description of the Company’s business activities. For additional information, see pages x-xx of Annex 1.

Segment #1. Brief description of the Company’s segment #1 activities. For additional information, see pages x-xx of Annex 1.

Additional Segments. Add similar descriptions and references for additional business segments.

### C) Financial Results

Included in the Company’s Annual Report/Public Security Market Disclosure Reports for the tax year ended 31 December 20XX, a copy of which is attached as Annex 1, are audited financial statements. During 20XX, the Company generated approximately 46% from American operations, 33% from European, Middle East and African Operations, and 21% from Asian and Pacific operations. The Company generated approximately 40% from Segment #1, 30% from Segment #2, 20% from Segment #3 and 10% from Segment #4. The Company’s 20XX financial results are also summarized, by business segment and country, in a chart attached as Annex 3.

#### 1. Related Party Transactions

During 20XX, the Company had related party transactions of approximately XXX million. A summary schedule showing the related party transaction is attached hereto as Annex 4.

#### **D) Functional Analysis.**

A chart summarizing the Company's risks and functions is attached as Annex 5. In addition, a description of the Company's business operations as well as a description of the risks and functions of the Company and its pertinent subsidiaries is attached hereto as Annex 6.

#### **E) Transfer Pricing Analysis under the OECD Guidelines**

##### 1. Background

The OECD Guidelines prescribe specified methodologies for determining the arm's length terms for the transfer of tangible property, intangible property, services, and capital between controlled taxpayers. In addition, the OECD Guidelines allow for the use of unspecified pricing methodologies where the specified methodologies set forth in the regulations are not applicable.<sup>2</sup> The arm's length result of a controlled transaction must be determined under the method that, under the circumstances, provides the most reliable measure of an arm's length result. The OECD Guidelines provide that the traditional transaction methods (i.e., comparable uncontrolled price, resale price, and cost plus methods) are preferable to other methods.<sup>3</sup> However, the OECD Guidelines provide that, if the traditional transaction methods cannot be reliably applied alone or cannot be applied at all, the "transactional profit methods" (i.e., the profit split or the transactional net margin methods) should be applied.<sup>4</sup> The discussion set forth in this paragraph E of the Transfer Pricing Report addresses which method is the best method for purposes of determining the related party transfer pricing of the Company.

##### 2. Transfer Pricing Method Selection

The OECD Guidelines provide that an appropriate method must be selected to evaluate the arm's-length nature of the intercompany transfer prices. The selected method should be the method that provides the most reliable result and takes two primary factors into account: (i) the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables; and (ii) the quality of the data and assumptions used in the analysis.

<sup>2</sup> OECD Guidelines ¶ 1.68.

<sup>3</sup> OECD Guidelines ¶¶ 2.49 and 3.49.

<sup>4</sup> OECD Guidelines ¶ 3.1.

The following analysis discusses the methods available for determining the reasonableness of the transfer pricing associated with the inter-company transactions between and among the Company and its foreign affiliates and documents the reasons for the selection of the transfer pricing method.

Important criteria for selecting an appropriate method involve the degree of comparability between the controlled and uncontrolled transactions, the reliability of assumptions used in the analysis, and the reliability of data.

As detailed in the next paragraph, the method was selected for the analysis of all related party transactions in this case.

*Transfer Pricing Method Selection.* Brief description of the selected method.

### 3. Review of Other Transfer Pricing Methods

Prior to selecting the transfer pricing method as discussed in paragraph E.2., we considered whether other transfer pricing methods set forth in the OECD Guidelines should be applied to determine whether the related party transactions between the Company and the Controlled Foreign Company (CFC) meet the arm's length criteria.

A summary of this analysis is set forth in the following table:

Best Method Analysis	
Method	Reasons for Rejection
Comparable Uncontrolled Price Method	Absence of comparable uncontrolled transactions.
Resale Price Method	Add brief explanation for rejection.
Cost Plus Method	Add brief explanation for rejection.
Transactional Net Margin Method	Add brief explanation for rejection.
Profit Split	Add brief explanation for rejection.

*Comparable Uncontrolled Price Method.* The Comparable Uncontrolled Price (CUP) method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction.<sup>5</sup> To utilize the CUP method, the taxpayer must establish that the products, contractual terms and economic conditions associated with the controlled transaction bear a close similarity to the products, contractual terms and economic conditions associated with the uncontrolled transaction.<sup>6</sup>

<sup>5</sup> OECD Guidelines paragraph 2.6.

<sup>6</sup> OECD Guidelines paragraphs 2.6 through 2.13.

Since the CUP method involves a direct comparison of related party prices with arm's length prices, the CUP method is normally preferred as a way to evaluate whether related parties transact at arm's length. In this case, any third-party transactions engaged in by the Company and its CFCs are either (1) not sufficiently similar to apply the CUP method or (2) reliable comparable uncontrolled transaction data were not available. Consequently, the CUP analysis was not selected as the best method for analyzing the majority of intercompany transfers in this case.

Resale Price Method. Brief description similar to paragraph E.3.a.

Cost Plus Method. Brief description similar to paragraph E.3.a.

Transactional Net Margin Method. Brief description similar to paragraph E.3.a.

Profit Split Method. Brief description similar to paragraph E.3.a.

#### F) Economic Analysis.

*As noted above, the transfer pricing policy of the Company is to charge \_\_\_\_\_. As can be seen from Annex 2, the Company had the following related party transactions.*

The Company has engaged XYZ Economics to conduct a search for independent, publicly listed firms comparable to the Company in terms of its operations and functions. A copy of the report titled "The Company's Transfer Pricing Analysis" is attached as Annex 7.

Based on the analysis, XYZ Economics concludes that the financial results for the selected companies are a comparable and reliable measure of transactions similar to that of the tested party. The 3-year average results for these companies are set forth in the following Table:

<b>Table</b>	
<b>Comparison of the Company's Related Party Transactions and Comparable Companies</b>	
<b>Returns Earned by Comparable Companies</b>	
Lower Quartile	2.5%
Median	5.0%
Upper Quartile	8.8%
<b>3-Year Return Earned by the Company</b>	<b>5.5%</b>

The 3-year return earned by the Company of 5.5% is within the inter-quartile range of the three year average mark-up established by comparable companies. Consequently, because the transfer pricing results for the related party transactions are within the range of comparable companies, we conclude that the transfer pricing of the Company and its related subsidiaries satisfies the arm's length principle of the OECD Guidelines.



## **G) Conclusion**

Based on the review of the financial information and documentation provided by the Company, we conclude that all related party transactions comply with the arm's length principle under the OECD Guidelines and local country law.

## **II. Local Country Transfer Pricing Requirements**

### **A) Local Country Transfer Pricing Legislation**

#### **1. Transfer Pricing Law and Administrative Guidelines**

Brief overview of local country transfer pricing legislation. If applicable add language similar to "the local country transfer pricing rules generally conform to the transfer pricing guidelines of the OECD."

#### **2. Documentation Requirements**

Brief overview of local country contemporaneous documentation requirements.

#### **3. Transfer Pricing Penalties**

Brief overview of any applicable transfer pricing penalties.

#### **4. Analysis and Conclusions**

Company Foreign is a foreign subsidiary of the Company ("CompFor"). To the extent that CompFor purchases or leases goods, or utilizes services from other group affiliates, the results for those aggregated transactions are described above and detailed in Annex 8, Local Country Financial Statement Information. In addition, a copy of the CompFor's Audited Financial Statements is attached as Annex 9.

As noted above, the XYZ Economics report concludes that the range of returns should be between 2.5% and 8.8%, with a median of 5.5%. CompFor's returns are 4.8% for 20XX as illustrated in Annex 8. CompFor's returns are well within the arm's length range of comparable companies. Therefore we conclude that the aggregated transactions involving purchase or lease of goods or services by CompFor satisfy the arm's length principle under local country law.

Given that the local country transfer pricing guidelines are substantially similar to the OECD Guidelines, the analysis in section I is directly applicable and addresses these matters in greater detail. In addition, as noted above, the analysis set out in this report meets the documentation requirements of local country.



**ANNEX 3**

SAMPLE INC. YE 12/31/XX	TOTAL PER ANNUAL REPORT	GEOGRAPHIC SEGMENT		
		AMERICAS	APJ	EMEA
		REVENUE	49,971	22,940
COST OF SALES	35,684			
GROSS PROFIT	14,287			
OPERATING EXPENSE	9,866			
OPERATING INCOME	4,421	2,074	876	1,471
OTHER INCOME/EXP	228			
EBIT	4,649			
OPERATING MARGIN	8.85%	9.04%	8.36%	8.89%
REVENUE BY PRODUCT/ SERVICE SEGMENT:				
	DOLLARS	% OF REV		
CAT # 1	20,021	40.07%		
CAT # 2	14,817	29.65%		
CAT # 3	9,797	19.61%		
CAT # 4	5,336	10.68%		
TOTAL REVENUE	49,971	100.00%		





SAMPLE INC SEGMENT SUMMARY 12/31/XX						
	TOTAL	SEG # 1	SEG # 2	SEG # 3	SEG # 4	ELIM & ADJ
SALES	49,971	20,021	14,817	9,797	5,336	-
COST OF SALES	35,684	15,032	10,160	6,166	4,336	-
GROSS PROFIT	14,287	4,989	4,657	3,641	1,000	-
OPERATING EXP	9,866	3,688	3,221	2,565	472	-
OPERATING INCOME	4,421	1,401	1,436	1,066	528	-
OTHER INC/(EXP)	228	152	79	(43)	40	-
EBT	4,649	1,553	1,515	1,013	568	-
TOTAL ASSETS	45,211	20,202	12,551	9,785	2,673	-
CURR LIABILITIES	8,098	4,009	3,123	584	382	-
OP. INC./SALES	8.95%	7.00%	9.69%	10.78%	9.90%	0.00%
I/C REVENUE:						
TANGIBLE PROPERTY	8,268	6,587	222	1,315	144	-
SERVICES	10,415	1,437	5,780	2,859	339	-
ROYALTY	542	542	-	-	-	-
INTEREST	121	121	-	-	-	-
DIVIDENDS	-	-	-	-	-	-
OTHER I/C REVENUE	-	-	-	-	-	-
	19,346	8,687	6,002	4,174	483	



SAMPLE INC									
SEGMENT # 1									
12/31/XX									
TYPE OF ENTITY				MFG, SP DIST	DIST	C MFG	DIST SP	DIST	MFG, SP DIST
	TOTAL	ELIM & ADJ	TOTAL BEF ADJ	COUNTRY #1	C # 2	C # 3	C # 4	C # 5	C # 6
SALES	20,021	(8,758)	28,779	11,312	3,021	944	2,810	910	9,792
COST OF SALES	15,032	(8,062)	23,094	8,723	2,846	829	2,165	622	7,909
GROSS PROFIT	4,989	(696)	5,685	2,589	175	115	645	288	1,873
OPERATING EXP	3,688	(1,496)	5,084	2,779	97	68	623	273	1,344
OPERATING INCOME	1,401	800	601	(190)	78	47	122	15	529
OTHER INC/(EXP)	152	(126)	278	151	(12)	5	67	19	58
EBT	1,553	674	879	(39)	66	52	179	34	587
TOTAL ASSETS	20,202		20,202	8,210	786	1,149	903	553	8,601
CURR LIABILITIES	4,009		4,009	1,620	224	378	466	231	1,090
OP. INC./ SALES	7.00%		2.09%	-1.68%	2.58%	4.98%	4.34%	1.65%	5.41%
I/C REVENUE:									
TANGIBLE PROPERTY	6,587			3,277	-	921	-	-	2,389
SERVICES	1,437			1,117	-	-	320	-	-
ROYALTY	642			642	-	-	-	-	-
INTEREST	121			92	-	-	-	-	29
DIVIDENDS	-			-	-	-	-	-	-
OTHER I/C REVENUE	-			-	-	-	-	-	-

ANNEX 4

	Income from inter-group transactions	TPM	Tested Party	Expenditure paid for inter-group transactions	TPM	Tested Party
<b>Tangible Property</b>	8,268					
<b>Services</b>	10,415					
<b>Royalties</b>	542					
<b>R&amp;D</b>	-					
<b>Interest</b>	121					
<b>Dividend</b>	-					
<b>Other (specify)</b>	-					
<b>Total I/C</b>	19,346					
<b>Total Sales</b>	49,971					
<b>IC / Sales</b>	38.7%					

## ANNEX 5

Risk-Function Summary			
Risk-Function Summary			
	Company 1	Company 2	Company 3
<b>Name of Company</b>	SCA	SGM	SUK
<b>Country of Residency</b>	Canada	Germany	U.K
<b>Relationship with Company (Parent/ Subsidiary/Associate/JV/Other-Specify)</b>	Subsidiary	Subsidiary	Subsidiary
<b>Classification of Entity (Manufacturer/ Distributor/Service Provider/etc.)</b>	Distributor	Distributor, Svc Prov	Mfg. Dist., Svc Prov
<b>A. Manufacturing</b>			
Manufacture of tangible goods			X
Assembly of tangible goods			X
Product development			X
Research and development of manufacturing intangibles			X
Inventory risk (including write-down, obsolescence and other adjustments)	X		X
Warranty risk	X		X
Ownership of manufacturing facilities and equipment			X
<b>B. Marketing, Sales and Distribution</b>			
Marketing activities in local market	X	X	X
Marketing development for local market	X	X	X
Marketing intangibles (for example, brand development and protection)			X
Sales	X	X	X
Training procedures	X		X
Customer support	X		X
Logistics			X
Warehousing	X		X
Ownership of distribution facilities	X		X
Product market/price risk	X	X	X
<b>C. Intellectual Property Ownership</b>			
Brands -owned outright			X
Brands - jointly owned/JVA			
Technology			X
Other (specify)			
<b>D. Financial Responsibilities</b>			
Currency risk for local market	X	X	X
Bad debt risk for local market			X
Currency exposure			X
Obligations to external lenders			X
<b>E. Administrative Support</b>			
Public relations	X		X
Human resources	X		X
IT			X
Accounting/Finance		X	X
Legal			X
Tax			X
Regulatory risk			X
<b>F. Financing</b>			
Inter-group lending			X
Inter-group guarantee fees			X



ANNEX 8

SAMPLE INC						
FOREIGN COUNTRY						
12/31/XX						
TYPE OF ENTITY	GLOBAL	TOTAL	DIST	DIST	SP	DIST
	per ANNUAL	COUNTRY	SEG # 1	SEG # 2	SEG # 3	SEG # 4
	REPORT					
SALES	49,971	2,009	910	459	341	299
COST OF SALES	35,884	1,605	622	376	294	313
GROSS PROFIT	14,287	404	288	83	47	(14)
OPERATING EXP	9,866	378	273	60	28	17
OPERATING INCOME	4,421	26	15	23	19	(31)
OTHER INC./(EXP)	228	105	90	13	(15)	17
EBT	4,649	131	105	36	4	(14)
TOTAL ASSETS	45,211	1,017	553	251	87	126
CURR LIABILITIES	8,098	374	231	46	40	57
OP.EARN./SALES	8.85%	1.29%	1.65%	5.01%	5.57%	-10.37%
I/C REVENUE:						
TANGIBLE PROPERTY	8,268	-	-	-	-	-
SERVICES	10,415	622	-	281	341	-
ROYALTY	542	-	-	-	-	-
INTEREST	121	-	-	-	-	-
DIVIDENDS	0	-	-	-	-	-
OTHER I/C REVENUE	0	-	-	-	-	-
TOTAL	19,346	622	0	281	341	0