Chapter 1: An Introduction to Transfer Pricing

1.1 What is Transfer Pricing?

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

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

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

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

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

1.1.6 In such a situation, it becomes important to establish the appropriate price, called the "transfer price", for intra-group, cross-border transfers of goods, intangibles and services. Transfer pricing is the general term for the pricing of cross-border, intra-firm transactions between related parties. "Transfer pricing" therefore refers to the setting of prices[2] for transactions between associated enterprises the transfer of property or services. These transactions are also referred to as "controlled" transactions, as distinct from "uncontrolled" transactions between companies that are not associated and can be assumed to operate independently ("on an arm's length basis") in reaching terms for such transactions.

1.1.7 "Transfer pricing" thus does not necessarily involve tax avoidance as the need to set such prices is a normal aspect of how MNEs must operate. Where the pricing does not accord with internationally applicable norms or with the arm's length principle under domestic law, the tax administration may

[1] The component parts of an MNE group, such as companies, are also called "associated enterprises" in the language of transfer pricing.
[2] However, in most cases the transfer pricing analysis will end after an appropriate profit margin has been determined. See Chapter [5] on transfer pricing methods

consider this to be “mispricing”, “incorrect pricing”, “unjustified pricing” or non arm’s length pricing, and issues of tax avoidance and evasion may potentially arise. A few examples illustrate these points:

- Consider a profitable computer group in country A that buys “flash-memory drives” from its own subsidiary in country B: how much the parent company in country A pays its subsidiary company in country B (the “transfer price”) will determine how much profit the country B unit reports and how much local tax it pays. If the parent pays the subsidiary a price that is lower than the appropriate arm’s length price, the country B unit may appear to be in financial difficulty, even if the group as a whole shows a reasonable profit margin when the completed computer is sold.

- From the perspective of the tax authorities, country A’s tax authorities might agree with the profit reported at their end by the computer group in country A, but their country B counterparts may not agree - they may not have the expected profit to tax on their side of the operation. If the computer company in country A bought its flash-memory drives from an independent company in country B under comparable circumstances it would pay the market price, and the supplier would pay taxes on its own profits in the normal way. This approach gives scope for the parent or subsidiary, whichever is in a low-tax jurisdiction, to be shown making a higher profit by fixing the transfer price appropriately and thereby minimising its tax incidence.

- So, when the various parts of the organisation are under some form of common control, it may mean that transfer prices are not subject to the full play of market forces and the correct arm’s length price, or at least an “arm’s length range” of prices (an issue discussed further below) needs to be arrived at.

- Consider next the example of a high-end watch manufacturer in country A that distributes its watches through a subsidiary in country B. Let us say the watch costs $1400 to make and it costs the country B subsidiary $100 to distribute it. The company in country A sets a transfer price of $1500 and the subsidiary unit in country B retails the watch at $1600 in country B. Overall, the company has thus made $100 in profit, on which it is expected to pay tax.

- However, when the company in country B is audited by country B’s tax administration they notice that the distributor itself is not showing any profit: the $1500 transfer price plus the country B unit’s $100 distribution costs are exactly equal to the $1600 retail price. Country B’s tax administration considers that the transfer price should be shown as $1400 so that country B’s unit shows the group’s $100 profit that would be liable for tax.

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

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

1.1.9 Though the above explanation of transfer pricing sounds logical and innocuous, arriving at an appropriate transfer price may be a complex task particularly because of the potential difficulties in identifying and valuing intangibles transferred and / or services provided. For example, intangibles could be of various different types such as: industrial assets like patents, trade types, trade names, designs or models, literary and artistic property rights, know-how or trade secrets. Sometimes such intangibles are reflected in the accounts and sometimes not. Thus, there are many complexities involved which have to be taken into account while dealing with transfer pricing in cross-border transactions between MNE entities.

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

1.2. Basic issues underlying Transfer Pricing

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

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

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

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

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

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

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

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

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

1.2.10 From the governments' perspective, the allocation of costs and income from the MNE resources needs to be addressed to calculate the tax. There sometimes tends to be a dispute between countries in the allocation of costs and resources owing to their objective of maximising the tax base in their respective nation states.

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

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

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

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

1.3. Evolution of Transfer Pricing

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

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

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

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

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

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

1.3.7 The on-going and continuous relocation of the production of components and finished products to particular countries; the rise of many new economies in the developing countries with their infrastructure, skilled labour, low production costs, conducive economic climate etc.; the round-the-clock trading in financial instruments and commodities; and the rise of e-commerce and web business are a few of the many reasons why transfer pricing has become such a high profile issue over the last couple of decades.

1.3.8 Other considerations have also had an impact on the current importance of transfer pricing. Some developed countries have tightened their transfer pricing legislation to address the issue of foreign enterprises active in their countries paying lower tax than comparable domestic groups. Consequently some developing countries have introduced equally challenging transfer pricing regulations in their

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

countries to keep their tax bases intact. Other developing countries are recognising that they need to address the challenges of transfer pricing in some way.

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

1.3.10 The OECD Committee on Fiscal Affairs continues to monitor developments in transfer pricing, in particular developments in the use of profit-based methods, and in comparability matters. The OECD Transfer Pricing Guidelines which have emerged out of Article 9 of the OECD Model Convention have also been relevant to the UN Model Double Tax Convention but some countries, especially developing countries, find it very difficult to implement such guidelines in practice. There are five different prescribed transfer pricing methods (described in more detail in subsequent chapters) that may be used in various situations to arrive at an arm's length price, but though all these methods may be able to provide a computation of the arm's length price (i.e., an appropriate transfer price) within the MNE, in practice disagreements between tax authorities in applying these methods may result in figures of taxable profits between two MNEs being either more than 100% or less than 100%. This situation could arise as a result of adjustments carried out by one tax authority without "corresponding adjustments" by the tax authority in the other country, in the absence of specific authorisation for such adjustments in the relevant double tax treaty between the countries.

1.3.11 The European Commission has also developed proposals on income allocation to members of MNEs active in the European Union (EU). Some of the approaches considered have included the possibility of a "common consolidated corporate tax base" and "home state taxation"[4]**.** Under both options transfer pricing would be replaced by formulary apportionment, whereby taxing rights would be allocated between countries based upon the apportionment of the European business activity of an MNE conducted in those countries under an agreed formula, based upon some indicia of business activity such as some formulary combination of sales, payroll, and assets. In recent years, the EU Joint Transfer Pricing Forum[5] has developed proposals to improve transfer pricing dispute resolution (mutual agreement procedure, arbitration and advance pricing arrangements), and a proposal to harmonise transfer pricing documentation requirements. The proposals on EU transfer pricing documentation requirements and on the implementation of the EU Arbitration Convention have been adopted as "codes of conduct" by the EU Council. Also worth mentioning are the guidelines on low-value-adding intra-group services, endorsed by the EU Council on 17 May 2011, on the basis that their implementation should contribute to reducing tax disputes. .

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

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

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

1.3.13 The United Nations (UN) is again taking a leadership role, through this Transfer Pricing Manual, in trying to arrive at updated global transfer pricing guidance which can be used by countries all over the world in developing (or calibrating) their transfer pricing regulations.

1.4. Concepts in Transfer Pricing

1.4.1 The UN Model Tax Convention Article 9(1) states the following *"Where*

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

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

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

1.4.2 In other words, the transactions between two related parties must be based on the "arm's length principle" (ALP). The term "arm's length principle" itself is not a term specifically used in Article 9, but is well accepted by countries as encapsulating the approach taken in Article 9, with some differing interpretations as to what this means in practice. The principle laid out above in the UN Model has also been reiterated in the OECD Model Tax Convention and the OECD's 1995 Transfer Pricing Guidelines as supplemented and amended (July 2010 version).

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

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

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

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

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

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

- Assume a corporation P (parent) manufactures automobile seats in country A, sells the finished seats to its subsidiary S in country B which then sells those finished seats in country B to unrelated parties (say, the public at large). In such a case S's taxable profits are determined by the sale price of the seats to the unrelated parties minus the price at which the seats were obtained from its parent corporation (cost of goods sold in the accounts of S, in this case the transfer price) and its expenses other than the cost of goods sold.

- If country A where the seats are manufactured has a tax rate much lower than the tax rate in country B where the seats are sold to the public at large, i.e. to unrelated parties, then perhaps corporation P would have an incentive to book as much profit as possible in country A and to this end show a very high sales value (or transfer price) of the seats to its subsidiary S in country B. If the tax rate was higher in country A than in country B then the corporation would have an incentive to show a very low sale value (or transfer price) of the seats to its subsidiary S in country B and concentrate almost the entire profit in the hands of country B.

- This is a clear example that when associated enterprises deal with each other their commercial or financial relations may not be directly affected by market forces but may be influenced more by other considerations. The arm's length principle therefore seeks to determine whether the transactions between related taxpayers (in this case corporation P and its subsidiary S) are appropriately priced to reflect their true tax liability by comparing them to similar transactions between unrelated taxpayers at arm's length.

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

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

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

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

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

Applying the arm's length principle:

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

a) Comparability analysis;

b) Evaluation of transactions;

c) Evaluation of separate and combined transactions;

d) Use of an arm's length range or central point in the range;

e) Use of multiple year data;

f) Losses;

g) Location savings and location rents;

h) Intentional set-offs; and

i) Use of customs valuation.

1.4.15 The above processes are discussed in detail in the chapter of this Manual dealing with comparability.

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

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

1.5. Transfer Pricing Methods

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

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

1.5.3 The five major transfer pricing methods (all discussed at Chapter 6 of this Manual) are:

Transaction based methods:

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

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

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

Profit-based methods

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

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

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

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

1.5.11 Other unspecified methods by which an arm's length price can be established: Other unspecified methods may be used to evaluate whether the amount charged in a controlled transaction is at arm's length. Any such method should be applied in accordance with the reliability considerations used to apply the specified methods described above. An unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. In establishing whether a controlled transaction achieves an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. These methods are discussed in detail at Chapter 6 of this Manual.

1.6. Special Issues Related to Transfer Pricing

Documentation requirements

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

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

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

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

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

(ii) *transaction-specific* documents (for example the details of each international transaction, functional analysis of the taxpayer and associated enterprises, record of uncontrolled transactions for each international transaction etc.), and

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

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

Intangibles

1.6.5 Intangibles (literally meaning assets that cannot be touched) are divided into “trade intangibles” and “marketing intangibles”. Trade intangibles such as know-how relate to the production of goods and the provision of services and are typically developed through research and development. Marketing intangibles refer to intangibles such as trade names, trademarks and client lists that aid in the commercial exploitation of a product or service.

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

1.6.7 The profit-split method is typically used in cases where both parties to the transaction make unique and valuable contribution. However care should be taken to identify the intangibles in question. Experience has shown that the transfer pricing methods most likely to prove useful in matters involving transfers of intangibles or rights in intangibles are the CUP method and the transactional profit split method. Valuation techniques can be useful tools in some circumstances.[6]

Intra-group services

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

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

[6] A similar recommendation is made in the OECD Report on Intangibles, op. cit. (Para 136)

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

Cost-contribution agreements

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

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

Use of "secret comparables"

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

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

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

1.7. Transfer Pricing in Domestic Law

Introduction

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

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

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

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

Safe harbours

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

1.7.6 Safe harbour rules are provisions whereby if a taxpayer's reported profits are within a certain range or percentage or under a certain amount that amount can be relied on by a taxpayer as an alternative to a more complex and burdensome rule, such as applying the transfer price methodologies. Safe harbours may often be used by the taxpayers at their option. There are some risks to safe harbours, such as arbitrariness in setting parameters and range, equity and uniformity issues, incompatibility with the arm's length principle, opportunities for tax planning and tax evasion and potential risk of double taxation. In any case, consistent with the purpose of this Manual, introducing a safe harbour rule should involve analysis of whether, in a broad sense, the administrative and simplification benefits of a safe harbour outweigh the potential costs of applying something other than the arm's length principle.

Controlled Foreign Corporation provisions

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

Thin Capitalisation

1.7.8 When the capital of a company is made up of a much greater contribution of debt than of equity, it is said to be *thinly capitalized*. This is because it may be sometimes more advantageous from a taxation viewpoint to finance a company by way of debts (i.e., leveraging) rather than by way of equity contributions as typically the payment of interest on the debts may be deducted for tax purposes whereas distributions on stock are non-deductible dividends. To prevent tax avoidance by such excessive leveraging, many countries have introduced rules to prevent thin capitalization typically by prescribing a maximum debt to equity rati**o**

Documentation

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

1.7.10 In deciding on the requirements for such documentation there needs to be, as already noted, recognition of the compliance costs imposed on taxpayers required to produce the documentation. Another issue is whether the benefits, if any, of the documentation requirements from the administration's view in dealing with a potentially small number of non-compliant taxpayers are justified by a burden placed on taxpayers generally. A useful principle to bear in mind would be that the widely accepted international approach which takes into account compliance costs for taxpayers should be followed, unless a departure from this approach can be clearly and openly justified because of local conditions which cannot be changed immediately (e.g. constitutional requirements or other overriding legal requirements). In other cases, there is great benefit for all in taking a widely accepted approach. See further Chapter 7 of this Manual which details the most widely accepted approaches.

Advance Pricing Agreements

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

APAs for developing country administrations and taxpayers, including some implementation issues, are addressed in Chapter 9.

Time limitations

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

Domestic transfer pricing rules and tax treaties

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

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

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

1. 7.16 That MNEs might use transfer prices to shift profits from lower tax countries to higher tax countries is a paradox, but happens in practice (e.g. to benefit from certain tax incentives in the high tax country or because there are losses in the high tax country that can be offset with profits from a lower tax country). MNEs may also have an incentive to shift profits to jurisdictions in which tax laws, such as transfer pricing rules, are not enforced. Transfer pricing is a 'zero sum game' - a situation in which the gain of taxable profits by one jurisdiction must be matched by a loss by the other jurisdiction. Consequently some international enterprises might set their transfer prices to favour a jurisdiction expected to enforce its transfer pricing rules, in order to minimise the risk of transfer pricing adjustments and penalties in that jurisdiction. Moreover, transfer pricing disputes are generally time consuming and expensive.

1.8. Transfer Pricing in Treaties

United Nations and OECD Model Conventions: An Overview

1.8.1 The OECD Model Convention[7] was first published in 1963 (draft version), then later in 1977 following up some work already done by the League of Nations; and then after World War II by the United Nations. The United Nations produced a UN Model Convention for treaties between developed and developing nations in 1980, with a new version produced in 2001[8]. The UN Model Convention has now been further updated, and was launched as the 2011 Update on 15 March 2012. The UN Model is in many respects similar to the OECD Model but the differences (such as preserving greater taxation rights to countries hosting investments) are very significant, especially for developing countries.

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

Transfer pricing and the Model Conventions

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

1.8.4 Other OECD Model Tax Convention articles which apply the arm's length principle include the article concerning dealings between the head office and a permanent establishment (Article 7(2)). Article 7(4)

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[7] A read-only but downloadable version of the OECD Model is available at: http://www.oecd.org/dataoecd/14/32/41147804.pdf

[8] The UN Model is available online at http://www.un.org/esa/ffd/tax/

previously explicitly permitted the use of the apportionment of total profit by countries customarily using it, provided the result was consistent with the arm's length principle, but this has been removed from the latest (2010) version of the OECD Model in a major re-write of Article 7.

1.8.5 The UN Model (2001) **also** contains similar provisions to the OECD Model in Article 9 and therefore serves as a guide for applying the arm's length principle for developing countries. However the UN Model also includes an additional paragraph which stipulates that a contracting state is not required to make the corresponding adjustment referred to in the second paragraph where judicial, administrative or other legal proceedings have resulted in a final ruling that by the actions giving rise to an adjustment of profits under Article 9(1) one of the enterprises concerned is liable to penalty with respect to fraud, or to gross or wilful default.

1.8.6 There is some ambiguity in the concept of "associated enterprises" in the context of the Model Conventions – the term is used in the heading of Article 9, but not in the text, for example. The Model Conventions use the concept to cover relationships between enterprises which are sufficiently close to require the application of transfer pricing rules. The "management", "capital" and "control" are concepts whose definition is extended under the domestic law in many countries. For example, if parties to the transaction make arrangements differing from those made by unrelated parties this could be considered to lead to a situation of "control". Also, sometimes a wider definition including both *de jure* (i.e., according to legal form) and *de facto* (i.e., according to practical reality) control, which are difficult to define, may be adopted based on the anti-avoidance provisions in domestic law.

1.8.7 The Model Conventions also spell out a key transfer pricing dispute resolution mechanism – the Mutual Agreement Procedure (MAP) – in Article 25**.** The MAP facilitates the settlement of disputes on corresponding adjustments among "Competent Authorities" (officials designated by countries to discuss treaty and other international tax-related issues with each other). Note that the Mutual Agreement Procedure does not guarantee relief as it is voluntary but there is a duty to negotiate in good faith to try to achieve a result consistent with the treaty allocation of taxing rights.

1.8.8 Finally, there are a small number of bilateral treaties which allow for arbitration to resolve transfer pricing disputes[9]. Also of note in this regard is the EU Arbitration Convention[10] which establishes a procedure to resolve disputes where double taxation occurs between enterprises of different Member States as a result of an upward adjustment of profits of an enterprise of one Member State.

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

Relevance of UN and OECD Models and OECD guidelines for developing countries

1.8.10 Transfer pricing rules have been developed mainly within the member countries, i.e., developed countries, of the OECD only because of their historical and economic backgrounds. Now many developing countries face some of the same conditions as the OECD countries did in the period from the 1970's to the 1990's. Thus, when it comes to the evolution of the UN Models and Guidelines, attention

[9] A paragraph relating to arbitration has also been included in Article 25 of the OECD Model Tax Convention.
[10] Convention 90/436/EEC 1990

should be focused on the following areas in which many developing countries are encountering difficulties with administering the arm's length principle.

1.8.11 Developing countries often have substantial problems with the availability of comparable transactions. This issue is considered more fully in a subsequent section and it suffices to note that due to a typically small domestic market in many developing countries, third party transactions comparable to the MNE's intra-group transactions are rarely discovered in the home market.

1.8.12 Documentation requirements should as far as possible be common between the two Models (UN and OECD), because diversity in documentation rules obliges excessive compliance costs on the MNEs, as well as smaller enterprises. Targeted documentation requirements can be an alternative to the full-scale documentation, in case transactions are simple and the tax due is not large. This may be especially important in responding to the needs and capabilities of small and medium enterprises (SMEs).

1.9. Global Transfer Pricing Regimes

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

1.9.2 By the end of 2011, there were around 100 countries with some form of specific transfer pricing legislation as shown by the light blue shading in the diagram below.

[List to be Updated]

1.10. Transfer Pricing as a Current and Future Issue

General issues with transfer pricing

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

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

1.10.3 It is widely accepted that transfer pricing is not an exact science and that the application of transfer pricing methods requires the application of information, skill and judgment by both taxpayers and tax authorities. In view of the skill, information and resource “gaps” in many developing countries, this can be very difficult for developing countries, often requiring their best officers, who may after skilling-up leave the organisation in view of their special skills. The intention of this Manual is to play a part in reducing those gaps.

Transfer pricing and developing countries

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

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

Lack of comparables

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

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

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

(c) In many developing countries whose economies have just opened up or are in the process of opening up there are many "first movers" who have come into existence in many of the sectors and areas hitherto unexploited or unexplored; in such cases there would be an inevitable lack of comparables.

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

Lack of knowledge and requisite skill-sets

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

Complexity

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

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

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

Growth of the "E-commerce economy"

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

1.10.13 The different kind of challenges thrown up by fast-changing web-based business models cause special difficulties.

1.10.14 From the viewpoint of many countries, it is essential for them to be able to appropriately exercise taxing rights on certain intangible-related transactions, such as e-commerce and web-based business models.

"Location savings"

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

1.10.16 Accordingly the determination of location savings, and their allocation between the group companies (and thus, between the tax authorities of the two countries) has become a key transfer pricing issue in the context of developing countries. Unfortunately, most international guidelines do not provide much guidance on this issue of location savings, though they sometimes do recognise geographic conditions and ownership of intangibles. The USA Section 482 regulations provide some sort of limited guidance in the form of recognising that adjustments for significant differences in cost attributable to a geographic location must be based on the impact such differences would have on the controlled transaction price given the relative competitive positions of buyers and sellers in each market. The OECD Guidelines also consider the issue of location savings emphasising that the allocation of the savings depends on what would have been agreed by independent parties in similar circumstances. This issue is dealt with in greater detail later in this Manual. An overview of location savings is provided at Chapter 5, at Para 5.3.2.4.5. and specific country practices on the use of location savings are provided at Chapter 10.

1.11 Summary and Conclusions

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

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

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

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

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