A.1. Introduction

A.1.1. This chapter provides background material on Multinational Enterprises (MNEs); MNEs are a key aspect of globalization as they have integrated cross-border business operations. The chapter describes the factors that gave rise to MNEs and shows how an MNE is able to exploit integration opportunities in the cross-border production of goods and provision of services through a value chain (or value-added chain).

A.1.2. MNEs are groups of companies and generally operate worldwide through locally incorporated subsidiaries or permanent establishments; they may also use other structures such as joint ventures and partnerships. At the operational level, an MNE's business operations may be organized in several different ways such as a functional structure, a divisional structure or a matrix structure. This chapter outlines the legal structures that may be used by MNEs, and considers the differences between them.

A.1.3. This chapter then uses a "value chain analysis" (see Paragraphs A.2.5 and A.3.5 below) as a measure for testing the performance of an MNE. It considers the management of the transfer pricing function in an MNE to minimize the risk of transfer pricing adjustments and to avoid double taxation. While MNEs test the performance of their business operations, for tax and company law purposes they are required to report the performance of associated entities in the countries in which they operate. An MNE's transfer pricing policy should provide guidance on: transfer pricing documentation requirements; reporting for transfer pricing purposes; dealing with audits; and appropriate measures for dispute resolution with a tax authority.

A.2. Theory of the Firm and Development of Multinational Enterprises

A.2.1. In economic theory, firms are organizations that arrange the production of goods and the provision of services. The aim of a firm is to produce goods and provide services to maximize profits. In the absence of MNEs, production would be carried out through a series of arm's length transactions between independent parties.[1] These transactions would require contracts between the independent producers but a significant part of these resources would be used in the process of making contracts.

A.2.2. The expenses of making contracts are called "transaction costs" since expenses are incurred by individuals in finding other persons with whom to contract, as well as in negotiating and finalizing the contracts. As contracts cannot cover every possible issue that may arise between the contracting parties there is a risk of disputes being created by unforeseen contingencies. When disputes occur between contracting parties they may incur considerable costs in resolving these disputes including negotiation costs, legal expenses, and litigation and mediation expenses. As transactions and associated costs would be significant in an economy without firms, it is rational for firms to be created to produce goods and services, provided that the firms' costs of production are less than the costs of outsourcing the production.

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[1] UNCTAD, "World Investment Report 1993: Transnational Corporations and Integrated Production", (New York, 1993). Available from http://unctad.org/en/pages/PublicationArchive.aspx?publicationid=640 at page 115; Ronald Coarse, "The Firm, the Market and the Law", (Chicago: University of Chicago Press, 1988) at page 7.

A.2.3. Within a firm, contracts between the various factors of production are eliminated and replaced with administrative arrangements. Usually, the administrative costs of organizing production within a firm are less than the cost of the alternative, which is outsourcing market transactions. The theoretical limit to the expansion of a firm is the point at which its costs of organizing transactions are equal to the costs of carrying out the transactions through the market.

A.2.4. A firm will internalize the costs of production to the extent that it can achieve economies of scale in production and distribution and establish coordination economies. The United Nations Conference on Trade and Development (UNCTAD) in its *1993 World Investment Report: Transnational Corporations and Integrated Production*[2] noted that in many industries the expansion of internalized activities within multinational enterprises indicates that there are significant efficiency gains that may be achieved.

A.2.5. A firm's functions in providing goods and services are collectively called its supply chain, through which the firm converts inputs into goods and services. Most firms begin by operating in their home market and rely on their competitive advantages to enter markets abroad. The term "supply chain" is defined as "the sequence of processes involved in the production and distribution of a commodity."[3] In this chapter the term "supply chain" is used for the provision of both goods and services by MNEs. The term "value chain" is defined in this Manual as "the process or activities by which a company adds value to an article, including production, marketing, and the provision of after-sales service."[4]

A.2.6. MNEs create organizational structures and develop strategies to arrange the cross-border production of goods and services in locations around the world and to determine the level of intra-entity or intra-group integration. UNCTAD considered that there was a trend in many MNEs across a broad range of industries to use structures and strategies with high levels of integration in their operations. The integration included structures giving an associated enterprise control over a group-wide function or the sharing of group-wide functions between two or more enterprises.[5]

A.2.7. Successful MNEs use their location and internalization advantages to maximize their share of global markets and growth opportunities. Thus, multinational enterprises are able to minimize their costs through their integration economies, which **are not available to domestic firms**.

A.2.8. The key feature of MNEs is that they are integrated (global) businesses. Globalization has made it possible for an MNE to achieve high levels of integration and the ability to have control centralized in one location. Modern information and communications systems also provide increased horizontal communications across geographic and functional business lines. This has resulted in many MNEs

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[2]UNCTAD, "World Investment Report 1993: Transnational Corporations and Integrated Production", (New York, 1993). Available from http://unctad.org/en/pages/PublicationArchive.aspx?publicationid=640 at pages 7 and 153-154 especially.

[3]Oxford English Online Dictionary.

[4]Oxford English Online Dictionary.

[5]UNCTAD, "World Investment Report 1993: Transnational Corporations and Integrated Production", (New York, 1993). Available from http://unctad.org/en/pages/PublicationArchive.aspx?publicationid=640 at page 158 and following.

providing services such as advisory, research and development (R&D), legal, accounting, financial management, and data processing from one or several regional centres to group companies. Also, management teams of an MNE can be based in different locations, leading the MNE from several locations.

A.2.9. In order to optimize the value chain, MNEs may establish new business operations in a developing country. These investments often happen in stages, with the initial stage involving the establishment of infrastructure, improvement of the **education of individuals and accordingly provision of economic benefits to the country**.

A.2.10. MNEs have common control, common goals and common resources, and the units of the enterprise — parent company, subsidiaries and branches — are located in more than one country. Thus, many MNEs are fully integrated businesses that plan and implement global strategies. UNCTAD has noted that integration of production by MNEs creates challenges for policy-makers in adapting the methods for allocating the income and costs of MNEs between jurisdictions for tax purposes.

A.2.11. In *Multinational Enterprises and the Global Economy* (2008)[6] the authors argue that the history of MNEs was shaped by political, social and cultural events that influenced the ownership, organization and location of international production of their goods and services. The authors claim that MNE groups integrated their operations until the late 1980s and then more recently chose to outsource some activities in which they do not have competitive advantages.

A.2.12. For most of the twentieth century, MNE groups and international enterprises operating through branches or subsidiaries tended to expand the range of their value adding activities and by the late 1980s firms had integrated their production and marketing functions. Up to the 1960s and 1970s, MNEs had engaged in limited or no outsourcing of operations and they became large integrated conglomerates. But the authors argue that from the late 1980s MNEs began outsourcing many activities that were previously performed by the firms themselves.[7] From the early 1990s, MNEs began restructuring to specialize in the areas in which they had competitive advantages, such as unique firm-specific assets, in particular high value intangible assets, and the capabilities that provided the firms with their market position and competitive edge.

A.2.13. MNEs examined their value chains to identify the functions in which they had no advantage over other firms.[8] They then began deciding on which functions they would perform themselves and which functions would be outsourced to independent firms, a process called value chain optimization. For in-house services, MNEs might decide to provide some services through centralized service centres. While the initial functions that were outsourced were non-core activities such as payroll, billing and maintenance services, outsourcing has expanded to cover core activities. The core activities may involve producing goods or providing services. For example, many firms outsource call centre activities or certain administrative functions to independent firms in countries which have educated workforces and relatively

[6]John Dunning and Sarianna Lundan, "Multinational Enterprises and the Global Economy", 2nd edition, (Cheltenham, Edward Elgar, 2008) at page 197.

[7]Refer to footnote 26, especially at page 196.

[8]Refer to footnote 26, especially at page 196.

low-cost labour. Consequently, modern MNE groups organize their cross-border operations through a network of contractual arrangements with independent enterprises and cooperative in-house relationships.

A.2.14. MNEs vary in size and include some small and medium sized enterprises (SMEs). When SMEs commence operating in other jurisdictions through locally incorporated subsidiaries they will usually incur the additional requirement of complying with transfer pricing rules. Some SMEs may face challenges in complying with transfer pricing rules because of their lack of expertise with international tax issues in general and limited compliance resources that may hinder them from expanding their operations abroad. Consequently, domestic transfer pricing rules which apply to SMEs should reflect the capacity of SMEs to comply and the capacity of the tax authorities to administer them. Some countries may have special simplified rules for SMEs, such as simplified documentation requirements, and may use flexible approaches in handling transfer pricing issues involving SMEs. This creates the need to define an SME. Although there is no universal definition, an SME may be defined on the basis of criteria including: turnover; balance sheet value; number of employees; and transaction values.

A. 3. Legal Structure

A. 3.1. General Principles of Company Law

A. 3.1.1. The legal systems used by countries include the common law and civil law systems. The common law system originates in the UK and is used in countries such as Australia, Canada, India, Malaysia, New Zealand and the USA. The common law is based on judgments in court cases. A judgment of a superior court is binding on lower courts in future cases. The civil law system has its origins in Roman law and operates in Europe, South America and Japan. Under a civil law system, law is enacted and codified by parliament. Companies are recognized under both systems as artificial legal persons with perpetual life and limited liability. The domestic law treatment of a partnership varies in common law and civil law countries.

A. 3.1.2. Most countries treat partnerships as fiscally transparent entities with flow-through treatment under which the partnership is ignored and tax is imposed on the partners according to their respective shares of partnership income. Other countries treat partnerships as taxable units subject to taxation as entities, including company treatment. Some countries such as the USA have limited liability companies which provide the benefit of limited liability and allow the entity to choose either flow-through treatment or treatment as a taxable unit. This is called the “check the box” system and the entities are referred to as “hybrids”. A feature of common law countries is the “trust” concept which is an obligation in relation to property which allows for concurrent legal and beneficial ownership of the trust property. A trustee will be the legal owner of property but holds the property on trust for the beneficiaries which may include both income and capital beneficiaries. While business operations may be carried on in some common law countries using a trust structure, MNEs would not normally use trusts to carry on business operations.

A. 3.1.3. One of the key decisions facing any MNE when expanding its operations to another country is the type of legal structure it will use to operate in that jurisdiction. The alternatives for an MNE are to operate abroad through locally incorporated subsidiary companies (associated enterprises) or operate

abroad using permanent establishments (branches). Foreign subsidiaries may be either fully-owned by the parent company or partly-owned.

A. 3.1.4. An MNE is a group of companies or other entities and under the company law of the country in which each company is incorporated it is a legal entity. This choice of legal structure will be affected by a number of factors, apart from the tax implications, including:

- Legal liability;
- Risk and control; and
- Administrative and regulatory obligations and costs.

A. 3.1.5. Other factors which may affect the choice of the legal form of the enterprise include:

- Exchange controls;
- Requirements for minimum shareholding by local persons or entities;
- Administrative costs;
- Extraction of profits; and
- Capital requirements.

A. 3.1.6. MNEs may also carry on business abroad through a partnership or joint venture. In most jurisdictions partnerships are not legal entities and are fiscally transparent. For a partnership to exist, an MNE would require other entities to be partners such as independent entities or subsidiaries. Joint ventures involve independent companies working together on a specific project and a joint venture party may include a government or a government authority. The business structures used by an MNE may change over time such as, for example, commencing operations in a jurisdiction using a joint venture structure and then buying out the joint venture partner and operating in that jurisdiction through an associated enterprise. An MNE may also operate abroad using an agent, which may be an independent agent, a dependent agent or a commissionaire.

A. 3.2. Companies and Permanent Establishments

A. 3.2.1. In an MNE group, the parent company and subsidiary companies are separate legal entities and they may enter into intra-group transactions. On the other hand, an international enterprise with a head office in the country of residence and permanent establishments abroad is one legal entity and a permanent establishment cannot legally enter into transactions with other parts of the enterprise because transactions require at least two legal entities. In the context of the Business Profits article of some tax treaties, notional transactions within an international enterprise (either between a head office and its permanent establishment or between permanent establishments) may be recognized provided they comply with the arm's length principle. In addition, for accounting and management purposes, the head office of an international enterprise and a branch may be treated as "transacting" with each other. Whether or not dealings between a head office and its branch are subject to transfer pricing rules would depend on the scope of a country's domestic legislation and its tax treaties.

A. 3.2.2. Operational structures used by MNEs vary and evolve over time. There are many types of structures or hybrids which an organization can choose to adopt, but an organization's primary aim should be to adopt an operational structure that will most effectively support and help it to achieve its business objectives. MNE operational structures usually differ from the legal structures and as a result, employees generally operate beyond and across the boundaries of legal entities and countries. Examples of the types of modern operational structures an MNE may adopt include a functional structure, a divisional structure or a matrix structure as outlined below.

A. 3.3. Types of Organizational Structures

A. 3.3.1. In a **functional structure** an MNE's functions are performed by the employees within the functional divisions. These functions are usually specialized tasks, for instance the information technology engineering department would be staffed with software engineers. As a whole, a functional organization is best suited to a producer of standardized goods and services at large volume and low cost to exploit economies of scale. Coordination and specialization of tasks are centralized in a functional structure, which makes producing a limited amount of products or services efficient and predictable.

A. 3.3.2. Under a **divisional structure**, each organizational function is grouped into a division with each division containing all the necessary resources and functions within it, such as human resources and accounts. Divisions can be categorized from different points of view. The distinction could for example be made on a geographical basis (e.g. a China division or a West Africa division) or on a product/service basis (e.g. different products for different customers: households or companies). For example, an automobile company may have a divisional structure with a division for hybrid cars and another division for other cars with each of these divisions having its own sales, engineering and marketing departments.

A. 3.3.3. The **matrix structure** groups employees by multiple criteria with the most common criteria being function and product. Alternative criteria would be function and geographic location. A matrix organization frequently uses teams of employees to accomplish tasks. An example of a function-geographic matrix structure would be a company that produces two types of products (A and B) in several geographic locations. Using the matrix structure, this company would organize functions within the company as follows:

Product A/Americas;

Product B/Americas;

Product A/Asia-Pacific;

Product B/Asia-Pacific;

Product A/Europe, Middle East, Africa (EMEA);

Product B/EMEA.

In terms of this matrix structure a person in the Product A division in Brazil may report to the Head of the Global Product A division and the head of the Americas division.

A. 3.4. Financial Reporting

A. 3.4.1. An MNE customarily maintains, parallel to its statutory accounts, a set of management accounts to mirror its operational structure in order to measure and report on the effectiveness of each operational unit for management purposes. Some of these divisions may be classified as cost centres for management account purposes (e.g. the human resources division) whilst others may be classified as profit centres (e.g. the product/services division). It is often challenging for an MNE to attempt to segregate the corporate and statutory financial statements to reflect the organization's operational structure.

A. 3.5. Value Chain Analysis

A. 3.5.1. The aim of MNEs is to maximize profits from producing goods and services. The key feature of an optimal MNE business is to produce a profit from exploiting resources which produce property or services of greatest economic value. A useful starting point to understand how an MNE operates is a value chain analysis which will also form the basis for a transfer pricing functional analysis. An MNE's value chain is used to convert its economic resources of lower value into economic resources of higher value which may involve the following steps:

1. Mapping out a generic value chain for the industry.
2. Mapping out an MNE's value chain.
3. Comparing the generic value chain to an MNE's value chain and analysing the differences which may explain why an MNE has a competitive advantage over its competitors.
4. Distinguishing between an MNE's main functions and its support functions.
5. Identifying and understanding which of the MNE's main functions are critical to the success of the organization (i.e. a critical success factor).
6. Identifying and understanding which activities performed by an MNE add value to the goods and services it produces, which may distinguish the MNE from its competitors, i.e. value-adding activities.
7. Understanding and confirming how the various functions across the value chain are split by the MNE between the various legal entities in the group.

A. 3.5.2. The following example shows how three different MNEs could adopt different operational structures using the same generic value chain.

MNE Group A uses three different companies to perform very specific functions across the value chain as follows:

> Company 1 in Country A is an R&D company carrying out research and also undertaking activities relating to the design of products for the entire group. A company of this nature would employ technical personnel such as engineers and scientists.

Company 2 in Country B is a fully-fledged manufacturing company (i.e. not a limited-risk contract manufacturer, for example) which also performs some functions on the design and practical application of its products.

Company 3 in Country C is responsible for the marketing, distribution and after-sales functions within the group.

MNE Group B uses two subsidiaries which perform some of the functions across the value chain and the group also outsources some of the activities to third parties.

Company 1 in Country A is an R&D company and carries out all the research and design activities in relation to the company's products. This company is similar to Company 1 of Group A, apart from the fact that the design function is fully located in Company 1 and not partly carried out by Company 2.

Company 2 in Country B is the company responsible for marketing and customer service. This company is therefore the customer interface for the group.

The MNE has decided to outsource the production and distribution functions to third party companies.

MNE Group C uses three companies to perform the same functions in different geographical locations using intangibles developed by a third party, which would typically be used by the group under licence.

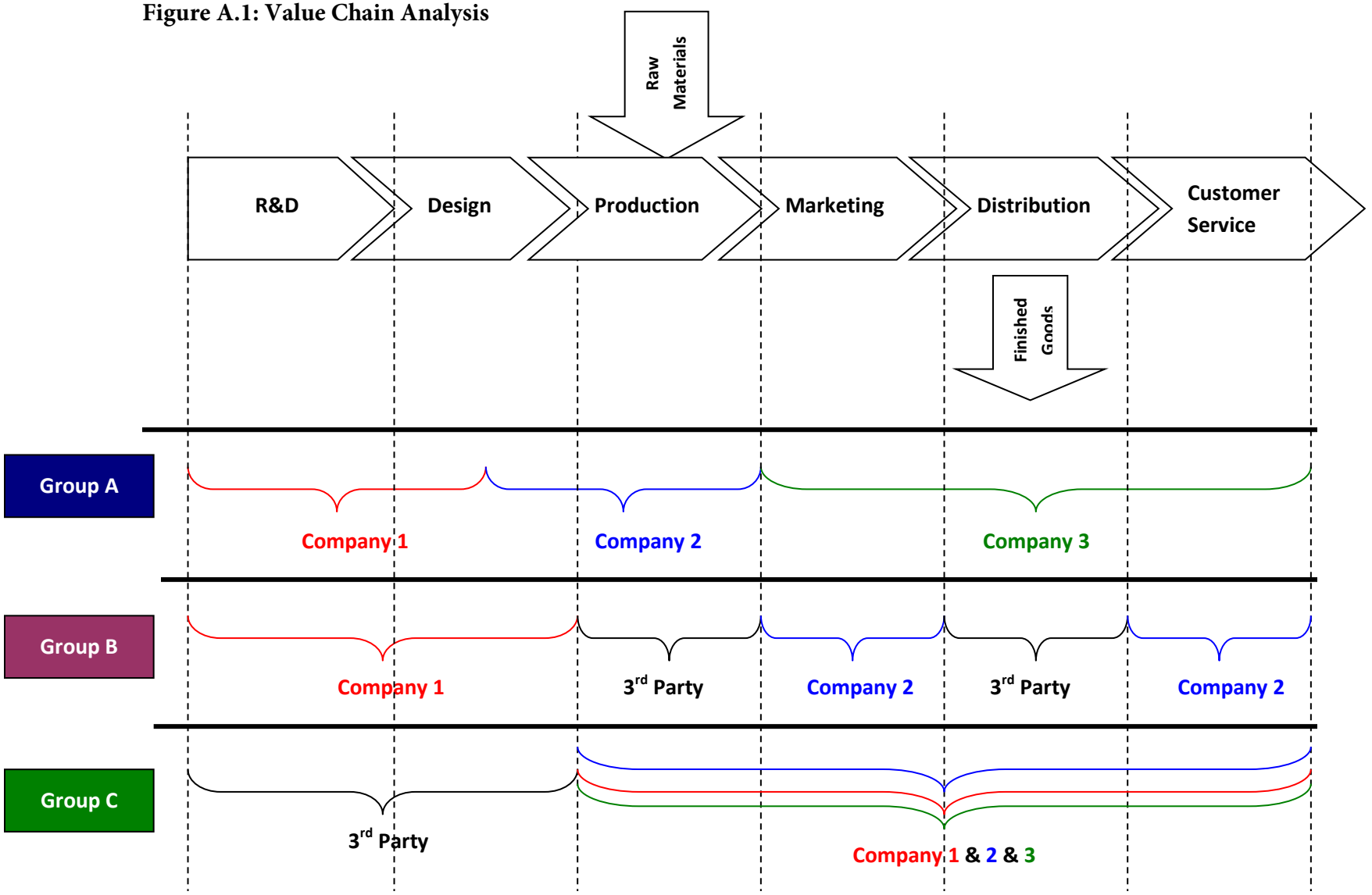
A. 3.5.3. In addition to understanding the value chain of an MNE, it is also important to understand the context in which each of the companies within the MNE contributes to the value chain, as this will ultimately be relevant in analysing the transfer pricing implications of the value chain.

A. 3.5.4. For example, in MNE group A (see Figure A.1 below) the value chain is defined as Company 1 performing R&D, Company 2 manufacturing, and Company 3 distributing the MNE's products. The value chain, however, may be different depending on the legal and contractual arrangements between the companies.

A. 3.5.5. One possible context could be that Company 1 performs R&D at its own risk, and is the legal owner of any intangible property developed through that R&D; Company 2 acts as a limited-risk contract manufacturer through a contractual arrangement with Company 1, and Company 3 acts as a limited-risk distributor through a contractual arrangement with Company 1. In this case, Company 1 is the legal owner of the intangible property of the MNE, and bears substantial risk associated with the manufacturing and sales of the MNE's products.

A. 3.5.6. A different possible context of exactly the same value chain could be that Company 1 performs R&D on a contract basis for Company 2, which is the legal owner of any intangible property developed through that R&D; and Company 3 acts as a limited risk distributor through a contractual arrangement with Company 2. In this case, Company 2 is the legal owner of the intangible property of the MNE, and bears substantial risk associated with the manufacturing and sales of the MNE's products.

Figure A.1: Value Chain Analysis



Examples of how different groups could "customise" the above generic value chain:

A. 3.5.7. A different possible structure of the same value chain could be that Company 1 performs R&D on a contract basis for Company 3, which is the legal owner of any intangible property developed through that R&D; and Company 2 acts as a limited risk contract manufacturer through a contractual arrangement with Company 3. In this case, Company 3 is the legal owner of the intangible property of the MNE, and bears substantial risk associated with the manufacturing and sales of the MNE's products.

A. 3.5.8. As will be discussed in subsequent chapters, each of these different contexts would very likely result in different transfer pricing outcomes.[9]

A. 4. Managing the Transfer Pricing Function in a Multinational Enterprise

A. 4.1. MNEs face challenges in managing their transfer pricing function. While transfer pricing may be used in some MNEs for management control, MNEs nevertheless are required to comply with the transfer pricing rules for tax purposes in the countries in which they operate. The determination of the transfer price affects the allocation of taxable income among the associated enterprises of an MNE group.

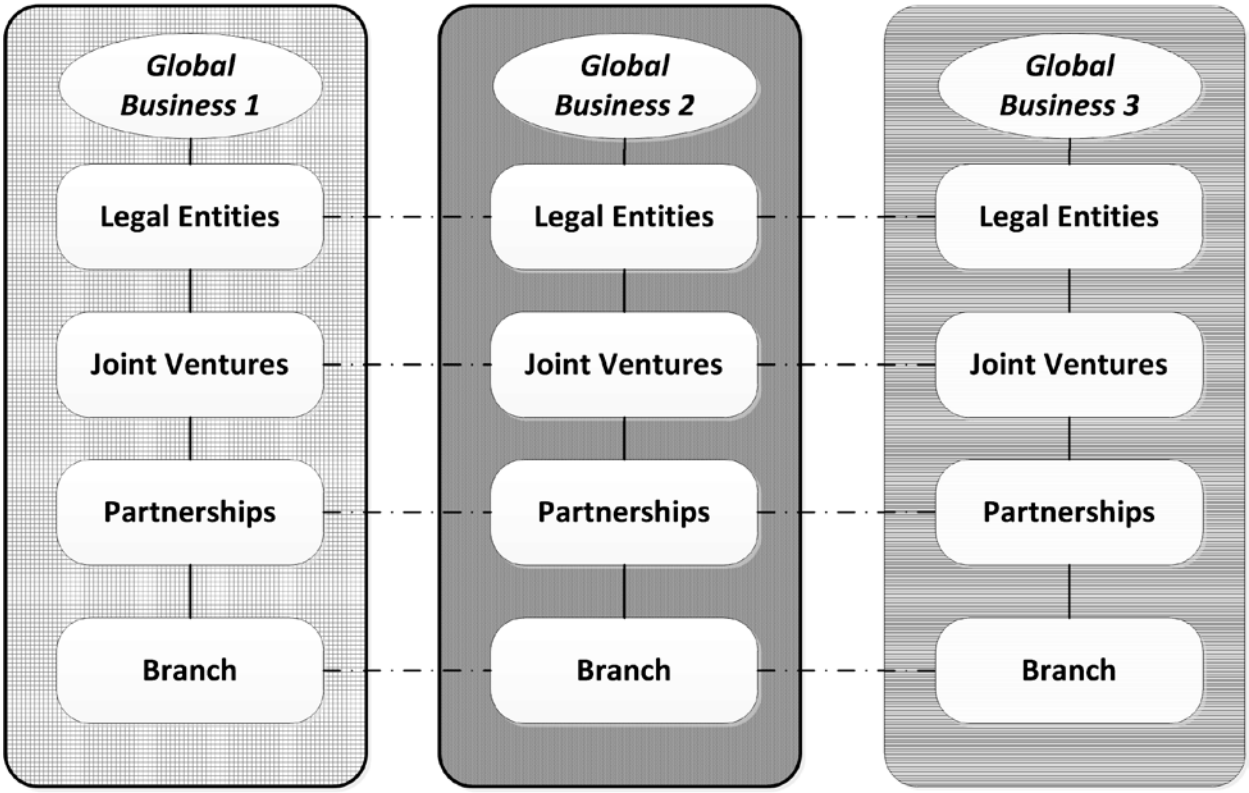
A. 4.2. Entities in an MNE group conduct global business that gives rise to opportunities to optimise the value chain of goods or services and therefore look for synergies. A challenge facing an MNE conducting a global business with associated enterprises is whether the transfer pricing method used for internal transactions is acceptable to the tax authorities in the countries in which the MNE operates. The transfer pricing challenge becomes even greater when the MNE has multiple global businesses with different business models and multiple cost centres. The size of the MNE adds to the complexity.

A. 4.3. Financial reporting for MNEs is informed by two decision trees. On the one hand, corporate and tax law require an associated enterprise to determine its taxable income derived from a specific jurisdiction. On the other hand, an MNE will usually need to determine for management purposes the income and costs of its businesses lines, which, as the previous discussion shows, can operate across several jurisdictions. In other words, while tax authorities focus on an associated enterprise's taxable income, an MNE's managers focus on income from their business lines. MNEs, particularly those where the parent is listed on a stock exchange, are more likely to aim to meet their tax obligations in the countries in which they operate provided that they are not subject to double taxation. Consequently, MNEs should develop and publicize within the enterprise a global transfer pricing policy to help minimize the risk of transfer pricing adjustments which may result in double taxation.

A. 4.4. The following is an illustrative example of the two different decision trees within an MNE:

[9] Contractual arrangements are not simply taken at face value by tax authorities. For example, each of these different possible contexts of MNE Group A's value chain would be subject to evaluation to ensure that the economic substance of the arrangements is consistent with the legal form of the arrangements, and that the terms of the arrangements are at arm's length.

Figure A.2: Multinational Enterprise Decision Trees



A.4.5. The allocation of profits and costs to the various legal structures is based on the functions performed, risks assumed and assets employed. Since MNEs consist of numerous associated enterprises it is very difficult to allocate the profits and costs to all the separate legal entities due to the absence of market forces. It is a complex exercise to come up with a consistent global policy for allocating results to the legal structures.

A.4.6. The arm's length principle allows national tax authorities to make an adjustment to the profits of one enterprise where the terms of transactions between associated enterprises differ from terms that would be agreed between unrelated enterprises in similar circumstances. A tax authority should only disregard a controlled transaction in exceptional circumstances. If the terms of a transaction between associated enterprises differ from those between unrelated parties and comparisons are difficult to make, an MNE bears the risk of transfer pricing adjustments. If the income of an associated enterprise within Country A is increased as a result of a transfer pricing adjustment, it would be reasonable to expect that there would be a corresponding transfer pricing adjustment resulting in a proportionate reduction in the income of the other associated enterprise in Country B, provided a consistent transfer pricing method is used by both countries.

A.4.7. But Country B may use different transfer pricing methods. Consequently, if transfer prices are adjusted by a tax authority in one country, double taxation will occur if the tax authority in the other country does not use the same transfer pricing method and allows a corresponding transfer pricing

adjustment. It is the task of the transfer pricing function within an MNE to limit the risk of transfer pricing adjustments and the risk of double taxation. See the illustration of double taxation below in Figure A.3.

A.4.8. In principle, designing, implementing and documenting an appropriate transfer pricing policy should not be viewed solely as a compliance issue for MNEs. The main goal should be to develop a consistent global policy which cannot be altered to exploit tax laws. A well-developed and consistently applied transfer pricing policy should reduce an MNE's risk of transfer pricing adjustments and the potential for double taxation, thereby increasing profitability by minimizing transfer pricing costs. Moreover, a global transfer pricing policy may be used as evidence in negotiations with tax authorities when transfer pricing disputes occur.

A.4.9. An MNE's transfer pricing policy should ideally reduce the risk of transfer pricing adjustments and the risks of double taxation of cross-border transactions. A comprehensive transfer pricing policy should cover four key areas as shown in Figure A.4.

- Advisory;
- Reporting;
- Documentation; and
- Audit support/Dispute resolution.

Figure A.3: Global Effect of Transfer Pricing Adjustments
(before adjustment)

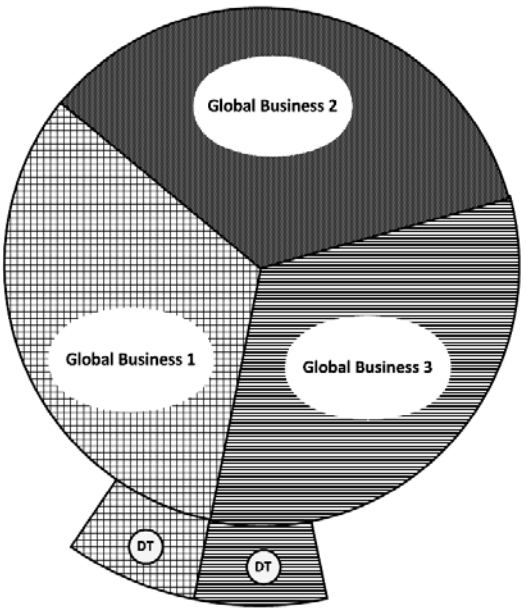
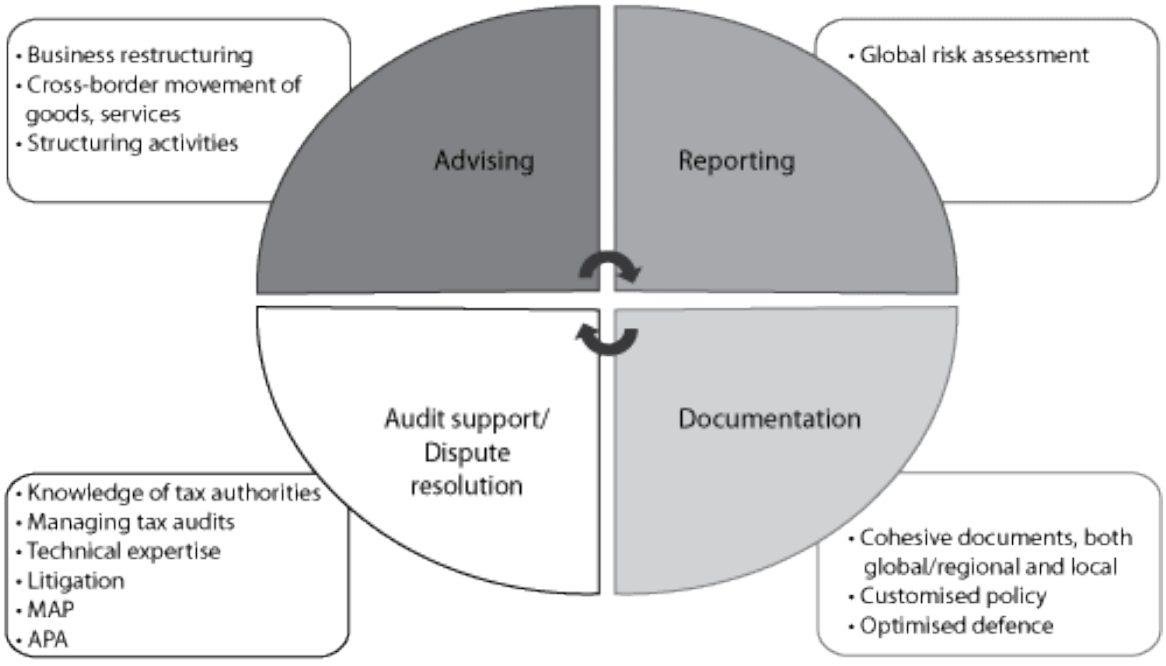


Figure A.4: Aspects of Transfer Pricing Policy



A.4.10. **Advising** requires a thorough knowledge of an MNE's business operations. It is a misconception that the tax department makes the key business decisions within an MNE. In practice, the business units of an MNE will identify business opportunities and a decision may be taken to exploit the opportunity if it fits into the MNE's global business strategy. Advice can be provided to minimize the risk of transfer pricing adjustments and therefore optimize the business opportunity if the tax department is involved in an MNE's decision-making.

A.4.11. In today's environment there is an increasing level of detail required to meet each country's transfer pricing documentation requirements. Most MNEs therefore prepare global and regional documentation (masterfiles) of the various global businesses. Subsequently, global and regional reports are prepared for local purposes based on the identified risks for each country in which the MNE operates.

A.4.12. Tax authorities around the world are increasingly focussed on transfer pricing and on expanding their transfer pricing capabilities. MNEs have to find a way to deal with the increasingly detailed, complex and often conflicting domestic transfer pricing legislation in the countries where they operate. Some countries follow guidance from international bodies, others only implement part of the guidance while some develop transfer pricing rules independently.

A.4.13. Tax authorities should not start from the assumption that MNEs are manipulating their results in order to obtain tax benefits. Many MNEs and certainly those with shares quoted on a stock exchange (listed MNEs) have published codes of conduct or a set of business principles or both. These codes or principles require that an MNE must comply with the tax rules of the countries in which they operate. Violations of these codes may result in severe consequences for a listed MNE.

A.4.14. As transfer pricing is often referred to as "an art, not a science", the resulting uncertainty creates the potential for transfer pricing disputes with tax authorities, even if the MNE is seeking to comply with domestic transfer pricing rules. Despite the efforts MNEs invest in setting the appropriate transfer prices and preparing comprehensive documentation, there is always the risk that tax authorities disagree with the approach taken and there is thus the risk of a transfer pricing adjustment. This creates uncertainty for MNEs including the potential associated costs of preparing additional documentation, managing tax audits and conducting litigation. Notwithstanding this, there are cases where transfer prices are manipulated to shift profits from one jurisdiction to another to gain tax benefits including low-taxation or no-taxation.

A.4.15. Transfer pricing rules are considered very useful by MNEs if they are able to achieve a globally consistent approach and eliminate the risk of transfer pricing disputes. If in one country an MNE's transfer prices are adjusted, resulting in a higher taxable income, the associated enterprise in the other country should in principle[10] receive a "corresponding adjustment", reducing its taxable income. If there is no corresponding adjustment, the MNE will suffer double taxation. In this situation, the dispute is between two tax authorities with the MNE seeking to have consistent transfer prices accepted by both countries.

A.4.16. Countries should try to avoid such double taxation, though in some cases there may be legitimate reasons why a corresponding adjustment is not given, or is less than the original adjustment. In

[10]UN and OECD Model Tax Conventions, Article 9 (Associated Enterprises).

such a case, it is important that the two countries enter into discussions to resolve the double taxation issue under the mutual agreement procedure mechanism in a tax treaty.

A.4.17. The following diagram illustrates a transfer pricing adjustment to relieve double taxation:

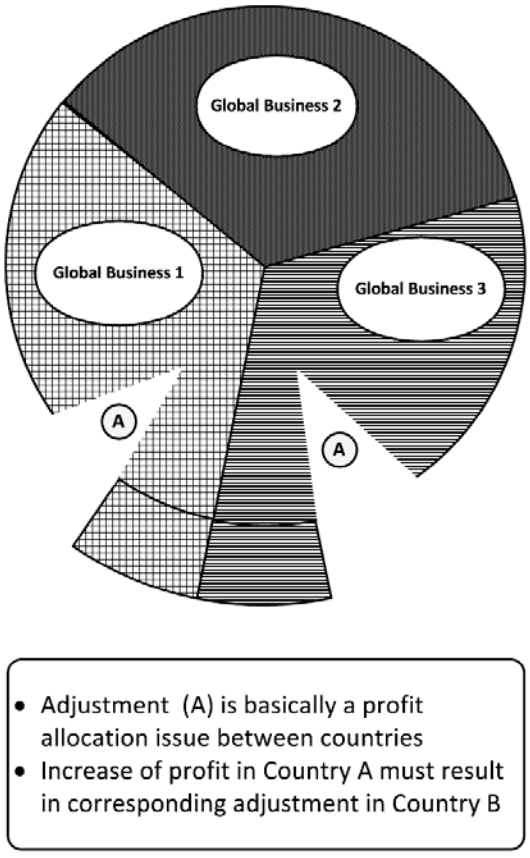



Figure A.5: Global Effects Transfer Pricing Adjustments
(after adjustment)