
**Committee of Experts on International
Cooperation in Tax Matters
Nineteenth session**

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Item 3 (d) of the provisional agenda

Update of the United Nations Practical Manual on Transfer Pricing for Developing Countries

Co-coordinators' Report on Work of the Subcommittee on Transfer Pricing

Summary

This note summarises work by the *Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing* towards updating the UN Practical Manual on Transfer Pricing for Developing Countries and attaches for consideration and guidance by the Committee, drafts of:

- A new chapter on Financial Transactions (Attachment A);
- Revised text on Profit Splits (Attachment C); and
- Revised text on Practical Implementation, Establishing Transfer Pricing Capability, Risk Assessment and Transfer Pricing Audits (Attachment F).

All of the above were first considered at the 18th Session and *approval for their inclusion in the next version of the UN Practical Manual is sought*; and

- A revised Chapter B.2 on Comparability (Attachment B);
- Revised and additional guidance on Group Synergies and Centralized Procurement Functions (Attachment D),
- A revised Chapter C.1 merging and updating former Chapter B.8 on the General Legal Environment and former Chapter C.1. on Establishing and Updating Transfer Pricing Regimes (Attachment E).

All of these latter three papers are being considered for the first time at the 19th Session. The *Committee's guidance on the proposed text is sought*.

The Attachments are ordered in the basic order in which they will appear in the updated Manual.

I. BACKGROUND

The Committee of Experts on International Cooperation in Tax Matters (“the Committee”) began its work on the United Nations Practical Manual on Transfer Pricing for Developing Countries (“the Manual”) in 2009, when it established its first Subcommittee on Transfer Pricing. The Manual was adopted by the Committee during its 2012 Session and was issued in print form in 2013. The second edition of the United Nations Practical Manual on Transfer Pricing for Developing Countries was finalized in 2017. The 2017 update improved the accessibility and relevance of the Manual and included, in response to developing country feedback, new chapters on intra-group services, cost contribution arrangements and treatment of intangibles.

II. THE MANDATE

2. During the 15th session of the Committee in 2017 a new Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing (“the Subcommittee”) was formed, to be Co-ordinated by Ms. Ingela Willfors and Mr. Stig Sollund, with the following mandate:

The Subcommittee is mandated to review and update the United Nations Practical Manual on Transfer Pricing for Developing Countries, based on the following principles:

- That it reflects the operation of article 9 of the United Nations Model Convention, and the Arm’s Length Principle embodied in it, and is consistent with relevant Commentaries of the United Nations Model;
- That it reflects the realities for, and the needs of, developing countries, at their relevant stages of capacity development;
- That special attention should be paid to the experience of developing countries, and the issues and options of most practical relevance to them; and
- That it draws upon the work being done in other forums.

The Subcommittee shall give due consideration to the outcome of the OECD/G20 Action Plan on Base Erosion and Profit Shifting as concerns transfer pricing. The Manual shall reflect the special situation of least developed economies.

The Subcommittee shall report on its progress at the sessions of the Committee and provide its final updated draft Manual for discussion and adoption no later than the 22nd Session in 2021 and preferably in 2020.

III. THE CURRENT SUBCOMMITTEE'S WORK

3. During the 17th Annual Session of the Committee, the Co-coordinators of the Subcommittee reported on progress made since the last meeting and on the next steps planned for the work of the Subcommittee. The Subcommittee comprises 27 participants from: tax administrations, academia, international organizations and the private sector, including from multinational enterprises and advisers. Subcommittee participants are organized in several drafting groups. Because of the many issues and perspectives in this area, a Subcommittee of this size and diversity has been considered optimum and has operated successfully.

4. As indicated at the 17th Session and approved by the Committee, the next version of the Manual, due by 2021, will make further improvements in usability and practical relevance, updates and improvements to existing text, including on Country Practices (Part D) and will have new content, in particular, on financial transactions; profit splits, centralized procurement functions and comparability issues. Enhanced capacity development recently based on the Manual has improved and contextualized developing country feedback, helped identify these priority areas for improvement and contributed to honing the messages in the Manual.

5. The Subcommittee had two meetings in New York in February 2018 (a special feedback session from capacity building work shops and for developing country inputs into the further work priorities) and May 2018 (where the workstreams and formation of drafting groups were decided). A third meeting took place in October 2018 in Quito, Ecuador, hosted by the government of Ecuador, where discussion focused on: (a) financial transactions; (b) centralized procurement functions; (c) comparability issues; (d) a general update of the Manual; (e) the update and revision of specific chapters of the Manual; (f) updating the text on profit splits; (g) part D of the Manual on country practices; and (h) the relationship between transfer pricing and customs valuation.

6. A fourth meeting in Vienna in February 2019 was hosted by the Austrian Ministry of Finance and the Vienna University of Economics and Business. At that meeting, further discussion and progress was made on most of those topics, including preparation of text for the 18th Session.

7. At a subcommittee meeting in Amsterdam on July 2-4, 2019 hosted by the Netherlands Ministry of Finance and the IBFD, Committee and broader feedback received at and since the 18th Session (including from the US Council for International Business) was considered in relation to updating the drafts presented at the 18th Session (at Attachments A, C and F in their updated form) as well as preparing texts on the following topics where texts are presented to the Committee for first discussion and guidance during the 19th Session:

- Comparability (Attachment B);
- Group synergies and centralized procurement functions (Attachment D),
- The general legal environment and establishing and updating transfer pricing regimes (Attachment E).

IV. DOCUMENTS FOR CONSIDERATION OR APPROVAL

8. The documents therefore attached for consideration by the Committee at its 19th Session are as follows:

(A) *Documents for a **second consideration and approval** after an initial consideration at the 18th Session:*

- **Attachment A:** the proposed new **Chapter B on Financial Transactions**. The draft discusses the importance of corporate financing decisions within multinational groups and how those decisions could lead to tax base erosion. The Chapter discusses interaction with rules and measures against base erosion; common types of intra-group financial transactions and of group financing departments; the process of actual delineation and relevant characteristics of financial transactions; the process and system of credit rating; potential transfer pricing methods, including the use of simplification measures/safe harbours; different types of intra group loans and relevant characteristics; determining the arm's length nature of intra-group loans; different types of intra group financial guarantees and relevant characteristics; determining the arm's length nature of intra-group financial guarantees; and available methods. The chapter also discusses cash pooling practices and captive insurance, without getting into further detail on the delineation and arm's length pricing of those specific transactions. Different types of intra-group loans are mentioned, and the draft identifies four steps to determine the arm's length nature of intra-group loans: (i) analyze economically relevant characteristics; (ii) accurately delineate the entire transaction undertaken as well as (iii) selection and (iv) application, of the most appropriate transfer pricing method.
- The text includes a series of examples that were not up for discussion at the 18th Session, but are now ready for Committee consideration.
- **Attachment C:** Revision to the guidance contained in the Manual on **the transactional profit-split method (Chapter B.3.3.)** with the focus being on seeking consistency of this guidance with the work done in the context of the Inclusive Framework on BEPS, while providing more practical examples. The draft includes the existing text side-by-side with the proposed revisions for better understanding. The draft is ready for Committee consideration, with one exception.
- Some text not ready for Committee consideration at the 18th Session now falls for Committee consideration.
- **Attachment F:** A draft of the work on sections **C.2. Establishing Transfer Pricing Capability in Developing Countries (previously C.5.); C.4. Risk Assessment (Previously part of C.3.) and C.5. Transfer Pricing Audits**. The purpose is mainly to streamline the sequences of presentation and to eliminate overlaps in the current text. No comments were received requiring amendment of this draft following the 18th Session, but a reference to Kenyan experience has been added.

(B) *Documents for a **first consideration by the Committee and guidance**:*

- **Attachment B:** the proposed revised **Chapter B.2 on Comparability**. A main purpose of this update on comparability is to seek consistency between the Manual

and the Platform for Collaboration on Tax Toolkit on Comparability¹ and, where useful, adding references to draw upon the practical guidance in the latter.

- **Attachment D: a revised Chapter C.1 merging the main content of former B.8 on the General Legal Environment and the former Chapter C.1. on Establishing and Updating Transfer Pricing Regimes.**
- **Attachment E: Revised guidance on Group Synergies, and additional guidance on Centralized Procurement Functions.** This section provides revised and clarified guidance on group synergies as well as additional guidance on how to analyse centralised procurement activities in an MNE group, the factors that may affect compensation for those activities, and the transfer pricing methods that may be appropriate. Additional guidance is appropriate because most MNE groups operate some form of centralised procurement, but the precise nature of the activities and their contribution to value can vary widely.
- This guidance helps to identify the functions that may be involved in centralised procurement activities, and the factors that can distinguish lower contributions to value from higher contributions. The draft addresses how the types of arrangements those in developing countries may come across can be analysed and addressed.

V. NEXT SUBCOMMITTEE MEETING

9. The subcommittee will hold a meeting at the UN facilities in Nairobi, Kenya on December 2-4, 2019. The meeting will aim to further progress the Update work, including addressing any issues raised by the Committee at the 19th Session and preparing a set of documents for first consideration by the Committee at its 20th Session.

10. The Nairobi Subcommittee meeting will be held in conjunction with an intermediate level regional transfer pricing capacity building workshop (5-6 December) designed to draw upon the expertise of Subcommittee Members in issues relevant to the region and to feed learnings of that event into the work of the Subcommittee and the next version of the Manual.

¹ <http://documents.worldbank.org/curated/en/447901498066167863/pdf/116573-REVISED-PUBLIC-toolkit-on-comparability-and-mineral-pricing.pdf>

**ATTACHMENT A: PROPOSED NEW CHAPTER B.1:
INTRA-GROUP FINANCIAL TRANSACTIONS**

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B.9. INTRA-GROUP FINANCIAL TRANSACTIONS

B.9.1. FINANCING ARRANGEMENTS WITHIN MNE GROUPS

B.9.1.0. Financial transactions between independent enterprises are based on various commercial considerations. Members of an MNE Group, however, have the flexibility and discretion to decide upon the conditions that apply to financial transactions within the group. As a result, in an intra-group situation, consideration of the tax consequences of the financial transactions may be present as well.

B.9.1.1. Financial transactions are an important part of the operating procedures of MNEs to support the value creation process of MNEs. Corporate treasurers have the responsibility to use their cash management function to help MNEs meet their financial and business obligations and challenges. They ensure steady cash flow, evaluate investment strategies and try to balance risk and reward. Debt management is an integral part of their responsibility, as it is common practice for MNEs to finance part of their operations through loans, or to reduce cost for external funding of their associated operating companies by issuing intercompany guarantees or through cash pooling activities. For intra-group transactions, MNE Groups may decide to allocate the financing responsibilities to separate financing entities within the MNE Group or centralize the treasury function at a (regional) headquarter company.

B.9.1.2. Intercompany financial transactions are subject to the arm's length principle just as intercompany services and other intercompany transactions are. As for any other intragroup arrangement, the application of the arm's length' principle requires the accurate delineation of the actual transaction (see B.2.3.), including the purpose of the financial transaction in the context of the business of the specific MNE. Guidance on these matters is provided in Section B.9.2.

B.9.1.3. In the case of financial institutions, like banks and insurance companies that are governed by supervisory authorities, central banks and multinational banking institutions and subject to licenses to operate (such as banks), a separate regulatory regime (Basel III rules) may influence intercompany financial transactions. This chapter does not address transfer pricing of financial transactions conducted within a regulated financial institution. The discussion and guidance in this chapter are tailored to non-financial MNE Groups that engage in intercompany financial transactions. Of the possible range of financial transactions that may take place intra-group, only a certain number of common financial transactions are explicitly discussed in this chapter. However, it does not matter whether the financial arrangements under examination in a particular case are similar to the more commonly encountered financial arrangements discussed in this chapter or present different features; what matters is the principle that the transfer pricing analysis of intra-group financial transactions follows the same analysis as that of other intra-group

transactions. These are the principles laid out in Chapter B.2. (Comparability Analysis), which describes the process by which the actual financial transaction can be accurately delineated and reliable comparisons found.

B.9.1.4. Several factors combine to make intra-group financial arrangements important for both taxpayers and tax administrations:

- The significance (in terms of amounts involved and frequency) of these transactions for MNE Groups;
- The fact that money is mobile and fungible, which makes it relatively simple for an MNE to shift debt to group companies and claim an interest deduction. This reduces taxable profits in the jurisdiction of the borrower, and can, depending on the situation of the group lender, reduce the MNE Group's overall tax liability.
- The difficulty that tax administrations face in determining the true character and characteristics of certain financial instruments;
- The concern that excessive interest deductions provide opportunity for tax base erosion;

For the above reasons, many countries have introduced tax measures aimed at reducing the tax advantages of debt financing.

B.9.1.5. This chapter will introduce the transfer pricing considerations for intra-group financial transactions, by first describing commercial considerations relating to corporate financing decisions and then presenting some of the more common types of intra-group financial transactions (section B.9.1.2.) as well as describing the operations of group financing departments/entities (section B.9.1.3.). After that it references corporate income tax approaches taken by tax administrations that address financing arrangements (section B.9.1.4. and describes the application of the arm's length principle to financial transactions in general (section B.9.2.), followed by sections specifically covering intra-group loans (section B.9.3.) and intra-group financial guarantees (section B.9.4.).

B.9.1.1. CORPORATE FINANCING DECISIONS

B.9.1.1.1. Corporate financing decisions are of fundamental relevance for an MNE Group. When an MNE Group seeks funding for its activities, it will have to choose between internal funding and external funding. Equity financing and debt financing; each have advantages and disadvantages that extend beyond tax considerations. Interest payments deriving from debt financing are generally deductible from the tax base of the payor and taxed at ordinary rates in the hands of the payee, whereas dividend payments, or other equity returns made to parties that provide equity financing are generally not tax deductible and often subject to some form of tax

relief (exemption, exclusion, credit, etc.) in the hands of the payee. This Chapter does not intend to address the economic benefits or disadvantages of corporate financing decisions.

B.9.1.1.2. Although there are many theories that have attempted to hypothesize the relevant factors defining an optimal corporate capital structure, it should be noted that numerous factors influence the decision of a company's Management Board when defining the capital structure of their firm. Transfer pricing rules do not serve to determine what capital structure is optimal for a company.

B.9.1.1.3. However, the capital structure of an MNE may impact the transfer pricing analysis of intercompany financial transactions. To closely assess the impact on intercompany financial transactions between MNEs of an MNEs capital structure, essentially a debt capacity analysis is required, however. This specific aspect is not further elaborated on in this chapter, and it is recommended to review the commentary under Article 9 in this respect.

B.9.1.2. COMMON TYPES OF INTRA-GROUP FINANCIAL TRANSACTIONS

B.9.1.2.1. Activities in an MNE require thinking about funding, such as: assuring cash flow for day-to-day operations, funding of a merger or acquisition, or making available credit facilities for operating companies. Depending on the amount of funding needed and length of time for which the amount of funding is needed, different financial instruments exist. A financial transaction might consist of an equity instrument, a contractual right or obligation to receive cash or another financial asset or to exchange financial assets or liabilities, or a derivative. Typical examples are equity instruments (e.g. common stocks), debt instruments (e.g., ordinary and special bank loans, ordinary and special bonds, commercial papers and money market instruments, debentures, government securities), and financial derivatives (e.g., foreign exchange transactions, stock options, futures, forwards, notional principal contracts, investment derivatives and other hybrids).

B.9.1.2.2. In an intra-group context, more common financial transactions include intra-group loans, financial guarantees by a parent for third-party loans undertaken by subsidiaries, cash pooling, hybrid financing, derivatives, and other treasury services (e.g., foreign exchange risk management, factoring and forfeiting, netting arrangements, payment factories, commodity risk management, captive insurance, asset management, carbon trading). Intercompany loans and intercompany financial guarantees are discussed in more detail in Chapters 9.3 and 9.4 *infra*, respectively.

B.9.1.2.3. Treasurers are generally concerned with how to ensure MNEs have access to cash to meet their anticipated needs, to secure cost-effective financing, and to provide financial risk management appropriate to the level of risk the MNE wishes to assume. For example, if an MNE operates internationally, it is likely to receive payments in different currencies. For planning and budgeting purposes, different currencies present variability of future cash flows (usually at a cost). Entering into a forward contract can hedge (and effectively fix) the amount of the future cost. Not hedging would leave the company exposed to the currency fluctuations and to uncertainty as to the actual cash flow. Group Treasury may monitor the risks, evaluate any natural hedges within the MNE Group, and price hedging contracts. Similarly, the obligation to buy commodities for production that are subject to volatility can cause substantial profit and loss volatility for a

company. It is not always possible to enter into fixed price contracts for commodities, and when it is possible, then it may be that fixed price contracts exclude the possibility to obtain further cost savings. The company's procurement department may therefore decide to work with the treasury department to evaluate a hedging arrangement. This chapter on financial transactions does not discuss hedging transactions.

B.9.1.2.4. MNE Groups not only rely on financing by cash flow, intercompany loans and revolving credit lines. They may issue bonds or securities in the market to fund or refinance existing loans as well. To get third party investors (more) interested in investing in the company's securities, a parent company guarantee may be provided in favour of the associated company that operates as issuer of record, when the issuer is a separate entity of the Group (e.g. the treasury entity). Similarly, a parent company may issue a guarantee to an independent bank that finances an associated group company with a low or insufficient credit rating, to improve the terms and conditions of the loan (e.g. to reduce the interest expenses) of the associated group company. Intercompany guarantees come in many forms and are discussed in more detail in Chapter 9.4 *infra*.

B.9.1.2.5. In case an MNE Group has subsidiaries in different countries, the different parts of the business may be independently responsible for their cash. If these different departments all act prudently, they all make sure they do not run out of cash and may end up holding on to slightly more money than they need for operating purposes. This means that they all hold average balances and that the treasury department of the MNE Group effectively draws more money on its revolving credit facility with a (third party) bank than it needs to. To reduce the cost of the credit facility (or not have to take out a loan for other needs) and to make more optimal use of the average balances sitting idle at the respective departments, the MNE Group's treasurer could consider putting in place a centralized cash pooling arrangement to net off the facility (i.e. target-balancing or zero-balancing cash pooling). There are also cash pooling arrangements where a bank combines the debit and credit balances of different entities or departments of the MNE to derive net balances on a real or notional basis. As a result, interest is credited on a positive balance and debited on a negative balance (i.e. notional or interest compensation cash pooling).

B.9.1.2.6. An intra-group cash pooling arrangement can generate numerous advantages, e.g. minimizing the liquidity requirements of the cash pool group, minimizing external interest cost for the group, ensuring flexible day-to-day financing of the cash pool participants, reducing transaction costs related to local bank accounts for all of the cash pool participants, increasing the bargaining power with banks and allowing obtaining conditions that are more advantageous (e.g., interest rates) on the common bank account, centralizing the financing decisions. This chapter on financial transactions does not discuss cash pooling transactions in further detail however.

B.9.1.2.7. Another common type of intra-group financial transaction is captive insurance. A parent group entity may create a licensed insurance company to provide coverage for the participating MNE group entities. The main purpose for doing so is to avoid using third party insurance companies, which have volatile pricing, and may not meet the specific needs of the company. By creating their own insurance company, the parent company can create stabilized premiums, reduce their costs, insure difficult-to-insure risks, have direct access to reinsurance markets, and increase cash flow. When a company creates a captive, it is indirectly able to evaluate the risks of subsidiaries, write policies, set premiums and ultimately either return unused

funds in the form of profits, or invest them for future claim pay-outs. Captive insurance companies sometimes are also set up to insure the risks of the group's customers. This is an alternative form of risk management. This chapter on financial transactions does not discuss captive insurance transactions in any detail.

B.9.1.2.8. The scope of this chapter will be limited to the analysis of intra-group loans and intra-group financial guarantees, since they are the most commonly seen financial transactions in practice. However, some of the guidance on these transactions might be relevant also for other financial transactions.

B.9.1.3. COMMON TYPES OF GROUP FINANCING DEPARTMENTS/ ENTITIES

B.9.1.3.1. Financial transactions can be performed and organized in many different ways within a group of companies. The organisation of the treasury will depend on the structure of a given MNE group and the complexity of its operations. Different treasury structures involve different degrees of centralisation. In the most decentralized form, each entity within the MNE group has full autonomy over its financial resources. Alternatively, a centralised treasury has full control over the financial resources of the group. That is, it centralizes some or all of various activities, such as cash and liquidity management, management of foreign exchange risk and interest rate risk, etc. In those situations, individual group members are mainly responsible for operational matters, less so for financial matters. Centralization of financing treasury and functions can offer significant scale benefits and financing cost savings for an MNE group.

B.9.1.3.2. Treasury departments/entities come in different types:

- Treasury departments/entities operating as cost centres: the treasury departments/entities operate essentially as service providers, assist group companies with routine services, and arrange transactions on their behalf but do not assume any risk of capital. Ensuring efficient use of cash and minimal financial volatility may be their main function.
- Treasury departments/entities operating as value added centres: the treasury departments/entities operate as cost-saving centres. They are more risk tolerant than their cost centre counterparts. They focus in addition on consolidating transactions and provide expertise to achieve net savings. To optimally perform, they need to be more centralized than pure cost centre treasury departments.
- Treasury departments/entities operating as profit centres: the treasury departments/entities operate as profit centre treasuries. They may seek profits by deliberately creating market positions, as well as actively managing operational exposures. To be able to manage operational exposures they tend to be centralized and in control. They may operate as in-house banks, maximize the profits of their own operations, and assume the risk of capital.

In practice, a combination of the profiles above is often seen.

B.9.1.3.3. The category of treasury department/entity that renders the specific financial transactions that are in place may be relevant and provide an initial indication of the most

appropriate method to be used to assess the arm's length nature of the intercompany transactions. To determine an arm's length remuneration for services rendered an accurate delineation of the actual transaction (including a functional analysis) is required. In this respect reference can be made to Chapter B.4. on Intra Group Services. Treasury departments/entities operating as service centres are typically remunerated by applying the CUP method, the cost-plus method, or the TNMM based on cost. Treasury departments/entities operating as profit centres, instead, are typically remunerated based on a pricing the various transactions allocating the credit risk of the transactions to the treasury department. Consequently, the 'spread' between costs of funding and return on cash invested will be mainly allocated to that treasury department/entity. To determine the arm's length remuneration for financial transactions such as loans and intercompany guarantees, reference is made to chapters B.9.3. and B.9.4. infra. Moreover, the 'substance' of these centralized activities generally requires careful review as well and are an important focus of the accurate delineation process.

B.9.1.4. CORPORATE INCOME TAX APPROACHES ADDRESSING MNE FINANCING DECISIONS

B.9.1.4.1. Raising corporate tax revenue can be especially important for developing countries. To the extent that a country's tax systems provide for income tax deductions for interest, there is an economic incentive for companies doing business in those countries to use debt financing. This is simply because of the previously mentioned tax advantage of debt financing.

B.9.1.4.2. To reduce the base erosion effect of debt financing and the relevance of the tax factor in choosing between equity and debt financing, some countries have made the tax policy choice to introduce in their domestic tax laws measures aimed at either reducing the advantage of debt financing or increasing the advantages of equity financing. These measures can be broadly grouped into General Anti-Avoidance Rules (GAARs) and Specific Anti-Avoidance Rules (SAARs). For a more in-depth discussion on the specific available measures to counter excessive interest deductions claimed by residents, reference is made to the UN Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest and Other Financing Expenses.¹ As discussed in the aforementioned Practical Portfolio, measures² to counter excessive interest deductions encompass pros and cons that must be carefully considered before implementing them, however.

B.9.1.4.3. One approach is to implement a rule that would limit net interest expense deductions based on earnings before interest, taxes, depreciation, and amortization (EBITDA).³

¹ Prepared by Professor Brian J. Arnold, Senior Adviser, Canadian Tax Foundation, Toronto, Canada and Peter Barnes, Duke Center for International Development, USA.

² These measures may include transfer pricing rules, treating shareholder debt as equity, thin capitalization rules, earnings-stripping rules, preventing tax treaties from preventing the application of thin capitalization or earnings stripping rules, or other measures.

³ As recommended by the OECD BEPS Action 4 Final Report. The following measures might complement this rule:

B.9.1.4.4. Banks, insurance companies and other financial businesses (leasing companies, asset management companies, companies subject to special tax regimes) might require special consideration in case the proposed base erosion rules are implemented, however.⁴ Addressing base erosion through excessive interest deductions is a relevant issue, also for developing countries, but choosing and implementing the rules requires careful and advance consideration of the possible tax policy consequences.

B.9.1.4.5. Interaction between the corporate income tax approaches addressing MNE financing decisions and specific decisions and specific transfer pricing rules might need careful consideration under domestic law, since both sets of rules might address similar issues and denying deductibility of similar expenses.

B.9.2. THE APPLICATION OF THE ARM'S LENGTH PRINCIPLE TO FINANCIAL TRANSACTIONS (IN GENERAL)

B.9.2.1.1 The assessment of the arm's length nature of an intra-group financial transaction essentially follows the same approach that applies for other intercompany transactions and is discussed in Chapter B.2.2. *supra*. It requires the identification of the commercial or financial relations (including an understanding of the economically significant characteristics of the controlled transactions) leading to the accurate delineation and recognition of the actual transaction, and, after that, the selection and application of the most appropriate transfer pricing method. In this chapter, for practical purposes, references are often made to loan transactions since they are a more common type of intra-group financial transaction. However, similar considerations apply to other types of intra-group transactions.

B.9.2.1. THE ARM'S LENGTH NATURE OF INTRA-GROUP FINANCIAL TRANSACTIONS

B.9.2.1.2. From a policy perspective the question regularly arises as to whether base erosion through excessive debt may also be tackled through application of the arm's length principle. Article 9 of the UN Model Convention embodies the arm's length principle. The commentary to

-
- Countries could adopt a "group ratio" rule to supplement the fixed ratio rule and provide additional flexibility for highly leveraged groups or industry sectors;
 - Countries could adopt rules that allow interest expense as long as the entity's debt-to-equity ratio is not in excess of that of the worldwide group;
 - Countries could allow for a carry-forward and carry-back with respect to disallowed interest expense or unused interest capacity;
 - Countries could disallow interest expense related to loans that fund public projects (such as infrastructure projects) and for entities with net interest expense that falls below a certain minimum threshold; and
 - Countries could provide targeted rules for remaining BEPS practices in this respect.

⁴ As recommended by the OECD BEPS Action 4 Final Report.

this UN Model Convention article references the OECD Commentary on Article 9, which in turn clarifies that the Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to capital. Based on the analysis in the UN Article 9 Commentary, (developing) countries have expressed the desire to use the concepts of Article 9 as embodied in their domestic transfer pricing rules for purposes of analysing the arm's length nature of intercompany financial transactions and determining not only whether interest charges are excessive but whether the financial transaction can accurately be delineated as debt. In this respect, reference is also made to paragraphs B.2.3.1.4. – B.2.3.1.9. of this Manual.

B.9.2.1.3. Considering the above, the analysis of the arm's length nature of financial transactions can arguably be conducted from several perspectives. First, it could be undertaken by (initially) accepting the transaction as an intercompany loan at face value, until the facts and circumstances of the transaction that are available for review (and possibly additional available evidence or conduct of the parties) leads to the decision that the transaction is commercially irrational. In case the latter conclusion is derived at, the financial transaction may be disregarded as an intercompany loan for transfer pricing purposes. That conclusion and decision arguably does not necessarily affect the civil law or common law denomination of the financial transaction, however. It only affects the transfer pricing analysis. In this first scenario, the transaction essentially is treated as how it is presented, until and unless it can be considered commercially irrational. Alternatively, a second scenario is that the analysis of the financial transaction could be conducted from the perspective of determining whether the economically significant characteristics of the transaction lead to the conclusion that the financial transaction sufficiently resembles and has the features or hallmarks of an intercompany loan (or more resembles something other than an intercompany loan). At a certain point the review of the combined available characteristics (and possibly together with additional available evidence or conduct of the parties) may lead to the conclusion that the intercompany financial transaction is not a loan. In that case, it may be that the financial transaction for transfer pricing purposes ought to be treated as something other than a loan. This conclusion arguably does not necessarily affect the civil law or common law denomination of the financial transaction, or its classification for accounting purposes, however. It only affects the transfer pricing analysis. Similar to the first scenario, if the facts and circumstances of the transaction available for review lead to the conclusion and decision that the transaction is commercially irrational, the financial transaction may be disregarded as an intercompany loan for transfer pricing purposes. The thirdly scenario involves the same process as the second scenario of determining the characteristics of the financial transaction. However, in this third scenario, it is also examined whether it is possible to conclude that the intercompany transaction in its entirety is not a loan, but (arguably only) part of it could be treated as an intercompany loan. Relevant evidence might for example include a debt capacity analysis of the borrower. In that case, it may be that the financial transaction for transfer pricing purposes gets treated partly as a loan and partly as something other than a loan such as a contribution to equity (see also the guidance in paragraph B.2.3.1.8.). Also in this third scenario, this conclusion and decision arguably does not necessarily affect the civil law or common law denomination of the financial transaction or classification for accounting purposes, however. It only affects the transfer pricing analysis. Furthermore, also in this third scenario, if the facts and circumstances of the transaction available for review lead to the conclusion and decision that the transaction as a whole is commercially irrational, the financial transaction may be disregarded as an intercompany loan

for transfer pricing purposes. Before concluding and deciding to bifurcate an intercompany financial transaction, tax authorities would be expected to have conducted a detailed analysis of the respective associated parties, including consideration of the purpose of the loan, economic circumstances, business strategies, creditworthiness, debt capacity and security offered etc. as outlined in paragraph B.9.2.1.5. below. In all three scenarios mentioned above, the treatment of the transaction as something other than a loan would for tax purposes, lead to a limitation in the deductibility of interest expense (entirely or partially) and not necessarily imply a characterization of the transaction as something else (e.g. and equity instrument).

B.9.2.1.4. The conclusion and decision to characterize a transaction between associated enterprises that is presented as an intercompany loan (in its entirety or partly) as something other than an intercompany loan requires careful analysis and should be based on adequate information, as a conclusion like this is likely to lead to double taxation (see B.2.3.1.5.). What type of scenario is used in analysing intercompany financial transactions, is essentially up to the tax authorities of the relevant jurisdiction, although it is recommended that tax authorities clarify which scenario is routinely and consistently followed under their domestic transfer pricing rules and guidance. The following section provides an overview of economically significant characteristics of a financial transaction that may be considered when assessing intercompany financial transactions for transfer pricing and benchmarking purposes.

B.9.2.1.5. Some of the economically significant characteristics of a financial transaction include the following:

- Contractual terms.⁵ Financial transactions between unrelated parties will usually provide for explicit terms and conditions. Between associated enterprises of an MNE, the contractual arrangements may be much less explicit. In that case, other documents and information may need to be consulted to determine the terms and conditions of the financial transaction and whether the actual conduct of the parties is consistent with those terms and conditions. Aspects generally included in the contractual terms of a financial transaction and to consider include:
 - (a) the price for obtaining the financing, which generally is the interest to be paid for obtaining financing. Interest may be fixed, floating or variable, paid annually, monthly, up front, upon repayment of the loan or on demand, but may also be a participation in profit or could be registered as being zero;
 - (b) the repayment obligations and (what happens upon) failure to repay (default) by the borrower are a material aspect of an intercompany loan;
 - (c) another relevant aspect will be the term (time-period) for which financing is provided. The term for which financing is extended may be short-term, long-term, fixed, undefined, perpetual, or eligible for amending midterm or subject to the right to (make or demand) early repayment, or automatically renewed;

⁵ It should be noted that the listed contract clause examples are not exhaustive.

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- (d) whether the amount of financing extended is secured by collateral, a guarantee or unsecured. This will impact the chances of repayment of the funding extended by the lender;
 - (e) the currency in which the loan is extended (and must be repaid) may be relevant;
 - (f) the status (subordination or preferred status) of the lender with respect to other creditors. Subordinated debt is debt that is ranked behind that held by secured lenders in terms of the order in which the debt is repaid. A creditor holding subordinated debt has a lower priority for the collection of its debt from its debtor's assets than a creditor with a preferred status; and
 - (g) convertibility of the funding (for example the right to convert the funding from debt into equity) for the borrower or lender will be relevant, if considered.
- Functional analysis: This analysis is relevant to determine what functions are performed by the respective parties (borrower and lender) in relation to the financial transaction. Facts and circumstances that may assist in determining the functions and responsibilities of the parties to the financial transaction may include:
 - (a) whether the debtor can obtain credit/funding from other sources (possibly including consideration of the debt capacity of the borrower);
 - (b) the (credit and other) risk of the lender in providing funding to this borrower;
 - (c) who conducts the monitoring of ongoing compliance with the terms of the funding agreement;
 - (d) for the borrower it could also include consideration of functions relating to ensuring availability of funds to repay a loan when due, i.e. considering the source of funds for repayment of the financing obtained;
 - (e) the (intended/actual) use of the funds/financing provided to the borrower;
 - (f) it may also include considering the purpose of the financial transaction in the context of the parties' businesses, what assets may be used and what risks are assumed in relation to the financial transaction and how those risks are controlled. The above analysis should consider "how those functions relate to the wider generation of value by the MNE Group to which the parties belong, the circumstances surrounding the transaction, and industry practices".
 - Characteristics of financial products or services: As already referenced in chapter B.9.1.2. supra and indicated under the Contractual terms mentioned above, there is a great variety of financial products or services. To accurately delineate the actual transaction, it is material that the characteristics of the specific financial transactions (or financial services) under review are clearly defined and supported by the conduct of the parties and other facts.

- Economic circumstances: Conditions (including the pricing) of financial transactions can greatly vary depending on the economic circumstances that apply when those financial transactions are entered into or take place. Aspects that may be considered include:
 - (a) the currency of the financial transaction;
 - (b) the geographic jurisdictions of the parties to the financial transaction or the geographic jurisdictions that are captured by the terms of the financial transaction that are involved,
 - (c) the specific business sector or industry in which the parties operate that enter into the financial transaction, and
 - (d) the timing of the transaction can all have a major impact on the price of a financial transaction. In addition,
 - (e) macro-economic trends will impact interbank lending rates and as such, may impact the (interest) cost of financial transactions. It is therefore important to ascertain what the relevant economic circumstances are.
- Business strategies: An MNE group’s global financing policy may have impact on how the intercompany financing transaction under review is structured. While accurately delineating the actual transaction, it will be helpful to have a clear understanding of the company’s financing strategy as discussed in B.9.1.1. supra. The intent of the parties with respect to the funding provided, participation in management and voting power by the party extending the financing all may be relevant considerations in this respect.

B.9.2.1.6. Determining the arm’s length nature of an intercompany financial transaction requires that the perspective of both parties to the transaction are considered. With respect to an intra-group loan, for example, this means that that the economically relevant characteristics of the transaction should be analysed from the perspective of both the lender and borrower. At arm’s length, a lender will conduct a credit assessment of the borrower to make the decision on whether to provide a loan, as well as on the amount and the terms of the loan. A borrower will generally assess whether the term of the loan will meet its commercial needs and fall within its debt capacity and will need to have the capability to make decisions relating to the risk it is purported to assume.

B.9.2.1.7. The arm’s length nature of a transaction initially should be considered by referencing the transaction actually undertaken by the associated enterprises as it has been structured by them. Tax administrations should examine the conduct of the parties and base the analysis of the financial transaction under review on the actual conduct of the parties. Based on domestic law or tax treaty considerations, it may be that the “label” applied to an intra-group financial transaction is not correct or the pricing of the transaction by the related parties is not at arm’s length. In that case, as discussed in B.9.2.1.2. above, the arm’s length principle may be applied to characterize an intra- group financial transaction as being different from that which was initially presented by the taxpayer.

B.9.2.1.8. Separately, it should be noted that in many jurisdictions there is likely to be domestic jurisprudence on the above relevant aspects as well, and their impact on the nature of transactions involving (intercompany) funding. Domestic jurisprudence will generally be relevant or even determinative for the characterization of an intercompany financial transaction. However, in instances where the character of an intercompany financial transaction as debt or equity is not clear and where jurisprudence does not provide persuasive guidance, consideration of the relevant aspects mentioned in this chapter may serve to analyse the intercompany transaction.

B.9.2.1.9. Once the intercompany financial transaction is accurately delineated, the most appropriate transfer pricing method can be selected and applied. Within this process, potentially comparable financial transactions can be identified, and comparability adjustments might be applicable, to determine the arm's length price or profit (or range of prices or profits) for the financial transaction(s) under review.

B.9.2.2. CONSIDERING THE CREDITWORTHINESS OF ASSOCIATED ENTERPRISES

B.9.2.2.1. To accurately delineate the actual financial transaction and to be able to seek reliable comparables to test the arm's length nature of the intercompany financial transaction the creditworthiness of the associated enterprises involved in the intra-group financial transactions may need to be considered. This regards the potential that the counterparty of a financial transaction will fail to meet its payment obligations in accordance with the terms of the transaction (in this respect mention is also made of "debtor" or "issuer" credit rating, where the term "issuer" indicates the debtor). In the case of intra-group loans, this essentially involves, inter alia, consideration of the security of the lending (that is, what collateral the borrower can offer) and consideration of future cash flows to pay interest and repay the debt. One way to assess debt capacity is to look at the credit rating of the debtor, which reflects the credit risk for the creditor extending debt to the specific debtor.

B.9.2.2.2. Credit risk may be measured by assigning a rating (i.e. credit rating) to the tested party. These ratings may be derived from independent commercial credit rating agencies. The rating expresses the probability of default. Some MNEs have developed in-house commercial tools that can be used for credit rating purposes. Official credit ratings provided by independent credit rating agencies generally consider qualitative and quantitative factors. Whereas credit rating methodology used by in-house commercial tools may mostly consider quantitative factors and not necessarily qualitative factors such as industry forecast, MNE Group Strategy and risk profile resulting from the MNEs management style. Determining a credit rating is not necessarily an exact science and can be particularly difficult for certain types of issuers such as start-ups, special purpose vehicles, or indeed for individual members of an MNE group. The process relies on both quantitative and qualitative factors, and there is likely to be some variance in creditworthiness between issuers with the same credit rating. In the case of a credit rating determination for a member of an MNE Group, the financial metrics used in the process may be influenced by related party transactions. Credit rating agencies tend to summarize credit ratings as illustrated by the following table. It should be considered that, however useful, credit ratings are only an indication

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of an entity’s probability of default. Although credit ratings are important and useful, they may not always be perfect. For example, in the 2009 financial crisis, some entities with high credit ratings nevertheless ended up going bankrupt. Furthermore, in some developing countries the government may have official prescribed interest rates in place and no use is made of international commercial credit rating approaches.⁶

Table 1.

Moody’s	S&P	Fitch	Interpretations⁷
Investment Grade Ratings			
Aaa	AAA	AAA	Highest quality; extremely strong, highly unlikely to be affected by foreseeable events.
Aa1	AA+	AA+	Very high quality; capacity for repayment is not significantly vulnerable to foreseeable events.
Aa2	AA	AA	
Aa3	AA-	AA-	
A1	A+	A+	Strong payment capacity; more likely to be affected by changes in economic circumstances.
A2	A	A	
A3	A-	A-	
Baa1	BBB+	BBB+	Adequate payment capacity; a negative change in environment may affect capacity for repayment.
Baa2	BBB	BBB	
Baa3	BBB-	BBB-	
Below Investment Grade Ratings			
Ba1	BB+	BB+	Considered speculative with possibility of developing credit risks.
Ba2	BB	BB	
Ba3	BB-	BB-	
B1	B+	B+	Considered very speculative with significant credit risk.
B2	B	B	
B3	B-	B-	
Caa1	CCC+	CCC	Considered highly speculative with substantial credit risk.
Caa2	CCC	CCC	
Caa3	CCC-	CCC-	
Ca	CC	CC	May be in default or wildly speculative.
Ca	C	C	In bankruptcy or default.
C	D	DDD	

B.9.2.2.3. In general, when applying the arm’s length principle, the starting point is that the related parties involved in the financial transaction should be treated as if they were entities independent of each other, but otherwise in the same circumstances. However, “the same circumstances” must include any incidental benefits and group synergies that derive from the fact that the related entities belong to an MNE group. This would include the impact of any implicit support (sometimes also referred to as ‘passive association’, ‘parent support’, or ‘group support’). To the extent that a borrower that is a member of an MNE group benefits from an improved credit rating solely on the basis of implicit support, no payment is required to be made for this benefit.

⁶ Reference can be made to credit rating rules that are applicable in Mexico and China.

⁷ Please note that the interpretations provided in the column above are only an indication and not a definition of the mentioned rating. The ratings provided are an illustration of long-term issuer rating/debtor ratings, from 3 public rating agencies. For short term debts the ratings may be different, however.

B.9.2.2.4. However, credit ratings from independent professional rating agencies such as Standards & Poor's, Moody's or Fitch, are typically only available for the parent company of the group. Where no such independent credit rating is available for the borrower of the funds, consideration will therefore need to be given as to how to evaluate the credit risk of that borrower. The following approaches may be considered:⁸

- Beginning with the parent's credit risk, adjust this credit risk (if required) to approximate the credit risk of the borrower;
- Derive the borrower's credit risk by using various credit scoring tools.

The effect of any implicit support available to the borrower would need to be factored into the analysis irrespective of the approach taken.

B.9.2.2.5. When assessing the credit rating of the associated enterprise, (i) the circumstance that the associated enterprise belongs to an MNE group (having, most probably, an overall higher credit rating than the associated enterprise's 'stand-alone' rating) and (ii) that, reasonably, the parent company of such an MNE group will support its affiliates (and, especially, its core affiliates) in their financial needs (referred to as 'stewardship by the parent company') should be considered as relevant elements when assessing the credit rating of the associated enterprise and whether these circumstances could trigger a higher credit rating to be assessed for the associated enterprise. The answer to this question may significantly influence the analysis of the arm's length conditions of the overall transaction. An improved credit rating for an associated enterprise based merely on so-called passive association does not merit a return or payment, at arm's length.

B.9.2.2.6. As regards the credit rating observations presented above, it might be relevant to consider the following questions:

- To what extent (if any) would implicit support be taken into account by independent institutions (e.g., independent lenders or credit agencies) when assessing the credit risk of the borrower?
- How would the implicit support be quantified?

B.9.2.2.7. In practice, the answers to the above questions will depend in large part on the level of strategic importance that the borrower has in the group (including the potential consequences of a default by the entity on the rest of the MNE group).

- If the consequences of not supporting the borrower would create negative impact on other parts of the group (for example due to legal obligations, operational impact, effect on group reputation, etc.);
- If there are explicit statements of policy/intent by the parent/group to support the borrower;
- If there is a history of support to group entity borrowers in cases where they get into financial difficulties.

⁸ There are additional approaches used in practice that may lead to an approximate credit rating for the borrower such as looking at third party loans of the borrower and based on those third-party loans re-engineering the credit rating of the borrower.

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The following table is an example of the possible effect of such levels of strategic importance on the credit rating of a borrower:⁹

Table 2.

Strategic importance of the specific entity for the group	Brief explanation of the strategic importance	Potential long-term credit rating of the specific entity
<i>“Top down” approaches</i>		
<i>Core</i>	Integral to the group’s current identity and future strategy. The rest of the group is likely to support these entities under any foreseeable circumstance.	Generally, at group level
<i>Highly strategic</i>	Almost integral to the group’s current identity and future strategy. The rest of the group is likely to support these entities under almost all foreseeable circumstances.	Generally, one notch below group level
<i>“Bottom-up” approaches</i>		
<i>Strategically important</i>	Less integral to the group than highly strategic entities. The rest of the group is likely to provide additional liquidity, capital or risk transfer in most foreseeable circumstances. However, some factors raise doubts about the extent of group support.	Generally, three notches above stand-alone rating
<i>Moderately strategic</i>	Not important enough to warrant additional liquidity, capital or risk transfer support from the rest of the group in some foreseeable circumstances. Nevertheless, there is potential for some support from the group.	Generally, one notch above stand-alone rating
<i>Nonstrategic</i>	No strategic importance to the group. These entities could be sold in the near to medium term.	Generally, stand-alone rating

It should be noted that implicit support does not equal an explicit guarantee and is generally unenforceable by a creditor of the borrower. Please also see section B.9.4. on financial guarantees.

B.9.2.2.8. It is also important to note that although implicit support is typically associated with a higher credit rating for the borrower, it might also be the case that the borrower’s credit rating is negatively influenced by the MNE group’s credit risk (i.e. as a result of negative synergies). In

⁹ Table 2 is based on S&P’s General Criteria: Group Rating Methodology (19 Nov. 2013). This is merely an example for evaluating code ratings and should not be regarded as prescriptive or definitive guidance. Please note that implicit support may also be considered and determined based on quantitative data, however.

addition to the credit rating of the debtor, for accurate delineation purposes the credit rating of the debt instrument that is considered is also relevant. See B.9.3.2.¹⁰

B.9.2.2.9. Where there are significant difficulties in determining the extent and effect of any implicit support, and in cases where there is substantial information asymmetry, challenges may be created in the transfer pricing analysis which, if not resolved, may result in outcomes that are not reliable. In such cases, the credit rating of the MNE group may also be used for pricing the accurately delineated loan where the facts so indicate, particularly in situations such as where the MNE is important to the group described above, and where the borrower's indicators of creditworthiness do not differ significantly from those of the group.

B.9.2.2.10. The next question is whether the credit rating of the associated enterprise/debtor should be established based on its creditworthiness before the financial transaction under review is put in place or afterwards. In most cases, the situation after the new financing transaction takes place must be considered.

B.9.2.2.11. In addition to the considerations above in determining the credit rating of a borrower, that is a member of an MNE group, it may also be relevant to consider the risk of an entity operating in a particularly risky country (i.e. the risk deriving from a country's business environment including legal environment, levels of corruption, and socioeconomic variables such as income disparity), to the extent that this is not already reflected in the credit rating of that entity. The country risk for developing countries tends to be higher than for developed countries due to perceived or real risk of currency fluctuations, political instability; economic risk such as recessions or higher inflation; the risk of default by the government on sovereign debt and the effect of foreign exchange and other controls. A loan provided to a borrower located in a country with high country risk will impact the business risk of that borrower and therefore also (likely decrease) the credit rating of that borrower.

B.9.2.3. CONSIDERING THE RISKS EMBEDDED INTO THE FINANCIAL INSTRUMENT

B.9.2.3.1. The credit rating of the debtor tends to be the first creditworthiness analysis to be conducted when analysing intercompany financial transactions. To accurately delineate the actual financial transaction and to be able to seek reliable comparables to test the arm's length nature of the intercompany financial transaction, the specific features of the financial instrument also play a role. If one considers that associated enterprise ACo makes available a loan to associated enterprise BCo, yet BCo already has obtained three different loans prior to this latest intercompany loan (regardless from what sources the previous three loans are), and the loan BCo gets from ACo is subordinated to the other three loans, then the "status" of the loan between ACo and BCo in essence is lower than that of the other three loans. If borrower ACo will only be entitled to claim repayment from BCo in case of BCo's bankruptcy after the latter has repaid the other three different loans, it holds a subordinated loan instrument with a higher risk. In the case

¹⁰ For additional information on how to measure credit risk and how to consider credit risk components, reference is made to the publication "Transfer Pricing Aspects of Intra-Group Financing" by Raffaele Petrucci.

of bonds (that may be used as a comparable for loans) this risk “status” is generally expressed as the “issuance” credit rating. For loans this could be referenced as “financial instrument-specific credit rating.” Thus, the credit rating of a specific financial instrument is also linked to the specific features of that particular financial instrument and not only to the risk profile of the borrower.

B.9.2.3.2. In practice, the credit rating of the financial instrument (financial instrument-specific credit rating) is generally notched down from the credit rating of the borrower (borrower’s credit rating), (usually) based on methodologies provided by credit rating agencies. When comparables are sought for the financial instrument, first the credit rating of the borrower is considered, and subsequently the credit rating of the financial instrument is estimated by adjusting the credit rating of the borrower, taking into account the features of the financial instrument.

For example, let’s assume that the credit rating of BCo is BBB, and the financial instrument provided by ACo to BCo is subordinated. And let’s assume that in line with the methodology provided by credit rating agencies, it is considered appropriate to apply a one-notch credit rating downgrade to reflect the subordinated nature of this financial instrument. Now, the credit rating of this financial instrument is BBB-, which is a one-notch credit rating downgrade based on the investment grade ratings (in this example of S&P and Fitch) presented in Table 1 supra. Different rating agencies have different approaches to this, however and there’s no universal approach. Regardless, the effect of subordination merits consideration. See also paragraph 9.2.1.5. supra.

B.9.2.4. POTENTIAL TRANSFER PRICING METHODS

B.9.2.4.1. Any of the prescribed methods in the Manual can be used to price financial transactions. With respect to intra-group loans), the most commonly used transfer pricing method to determine the arm’s length compensation for the transaction is, in general, the CUP method. The CUP method may be employed when comparable transactions exist between one party to the intra-group loan transaction and an independent party (“internal comparable”) or between two independent parties, neither of which is a party to the intra-group loan transaction (“external comparable”). This is discussed further in the subchapter 9.3 on intercompany loans infra.

B.9.2.4.2. Separate and apart from the pricing of individual intra-group financial transactions, treasury services rendered for the MNE Group are likely to require an arm’s length remuneration. With respect to treasury services, reference is also made to paragraph 9.1.2.3. supra. For these services, the cost-plus method or cost-based TNMM can be utilized (or in certain circumstances where the financing entity adds no value, remuneration at cost). It is common that one entity of the group (e.g., the financing department/entity) is acting as a general service provider or intermediary for other entities in the group. See also chapter B.4. on intra-group services. If a financing department/entity, however, provides financing to group members and refinances these with deposits from other group members or external sources and has, therefore, a mismatch in timing and/or currencies as well as exposure in creditworthiness, the cost-plus method might not be the appropriate transfer pricing method for that financing transaction.

B.9.2.4.3. Another method that could be used in some cases is the transactional profit split method. However, the use in practice of this method for this kind of transactions is quite limited (e.g. for global trading or for certain cash pooling transactions).

B.9.2.5. THE USE OF SIMPLIFICATION MEASURES AND SAFE HARBOURS

B.9.2.5.1. To simplify the determination of the arm's length price for intra-group financial transactions, a few countries have been introducing safe harbours, most of which concern interest rates. More specifically, some countries annually issue official interest rates that, if applied to the intra-group loans, extinguish the obligation for the taxpayer to prove the arm's length nature of the compensation related to those transactions, while providing some assurance that the intercompany rate will not pose a risk of base erosion.¹¹

B.9.2.5.2. Access to the credit rating of individual associated enterprises and the determination of the impact/effect of implicit support on intra group financing transactions are not easily available and are based on judgements/determinations that are very hard to be verified by tax administrations. Therefore, another consideration for simplification could be to use the MNE Group credit rating as basis when reviewing the arm's length nature of the financial transaction between the respective associated enterprises, if taxpayers do not corroborate the credit rating used. This approach has the added benefits of providing certainty and reduction in administrative burden to both tax administrations and taxpayers. See B.9.2.2.10. supra. The same approach could be considered if taxpayers do not sufficiently corroborate the interest rate used on intra group loans (by prescribing a basis point margin on top of a base rate).

B.9.2.5.3. When defining the arm's length amount of compensation for an intra-group financial transaction, the use of simplification measures or safe harbour rules should be carefully considered. Furthermore, it should be considered how the simplification measure or safe harbour interplays with the definition and application of the arm's length principle both on a domestic and on an international level. In some countries, taxpayers maintain the right to rebut a safe harbour rule or simplification rule and demonstrate the arm's length nature of the amount of compensation for the intra-group financial transaction. In others, no such option exists. As regards to the use of safe harbours, reference can be made to Chapters B.1.7.; B.4.5.; and B.8.8. of the Manual.

¹¹ As an example, Singapore provides a safe-harbour rule for intercompany interest rates which is rebuttable by taxpayers who want to substantiate the interest rate with a proper economic analysis and TP documentation. In general, the indicative margin is only applicable to related party loans below a certain amount (i.e. S\$ 15 million at the time the loan is obtained or provided). The indicative margin is published on the tax authority website and updated at the beginning of each calendar year. If the indicative margin applicable for the referenced period is +250 bps (2.50%), this means that if taxpayers choose to apply the safe-harbour rule for intercompany interest rates, they will apply the indicative margin on the appropriate base reference selected for the loan (i.e. LIBOR) and need not prepare TP documentation. However, if taxpayers choose not to apply the safe-harbour rule, they must substantiate an interest rate in line with the arm's length principle and maintain contemporaneous transfer pricing documentation. New Zealand issued guidance for small value loans (of up to 10 million NZ\$ principal in total) based on which taxpayers may apply a safe-harbour interest rate of 300 basis points (3%) on top of the relevant base indicator as broadly indicative of an arm's length rate, in absence of readily available market rate for a debt instrument with similar terms and risk characteristics (this safe harbour rate relates to 2019 and its indicative value is being revalued annually).

B.9.3. THE APPLICATION OF THE ARM'S LENGTH PRINCIPLE TO INTRA-GROUP LOANS

B.9.3.1. DIFFERENT TYPES OF INTRA-GROUP LOANS AND RELEVANT CHARACTERISTICS TO CONSIDER

B.9.3.1.1. This section illustrates the characteristics of an intra-group loan. An intra-group loan is the provision of financial resources from one related party (the lender) to another (the borrower) to be repaid at a later date. With an intra-group loan, the borrower will obtain the financial resources; the lender will generally assume the credit risk related to the intra-group loan and needs to be compensated for the liquidity provided and the risk taken on by an arm's length payment, i.e., an interest payment. Relevant terms and conditions of the loan ideally are specified in the loan agreement between the parties and should be supported by the conduct of the parties. If and to the extent that an MNE Group has specific (explicit) group policies in place with respect to the (target) cost of financing, the likely impact thereof (or not) on the characteristic of a particular loan might also be considered relevant.

B.9.3.1.2. In practice, many different types of intra-group loans exist. Two examples are provided below:

- **Term loan:** a loan with a specified schedule for the payment of interest and the principal amount¹², and a maturity ranging from 1 to 10+ years. Such loans are often used to fund medium- and long-term assets such as plant and equipment as well as average inventory levels. A term loan may be secured or unsecured, carry a fixed rate or a floating rate, and contain general or specific performance covenants.
- **Revolving loan or revolving credit facility:** a secured or unsecured credit line with a maturity ranging from six months to five plus years that a borrower can draw down and repay multiple times. A typical facility requires the borrower to pay the bank an annual commitment fee on the entire line in order to keep it available for future use; those without a fee are typically not committed and may be withdrawn by the bank at will. In some instances, banks require borrowers to repay the facility in full before allowing further draw-downs or renewals (a process known as a clean-up call).

B.9.3.1.3. Apart from the credit risk, the most common risks relevant in an intra-group loan will be interest rate risk, reinvestment risk, call/prepayment risk, inflation (or purchasing power) risk, liquidity risk, exchange rate (or currency) risk, volatility risk, political or legal risk, event risk, sector risk and country risk. During the accurate delineation process, the allocation of these risks will generally be considered. See Table B.2.4. in Chapter B.2.3.2.

¹² A so-called "bullet loan" on the other hand allows for repayment of the principal amount at the end of the loan term rather than through a specified repayment schedule.

B.9.3.1.4. When analysing an intra-group loan, relevant characteristics that may be considered include the following: conversion right, currency, guarantees, interest payments, options, repayment clauses, security provided, seniority and terms of the loan. Loan characteristics that benefit the borrower generally have the effect of increasing the interest rate and clauses that have the impact of benefitting the lender tend to decrease the interest rate.

B.9.3.2. DETERMINING THE ARM'S LENGTH NATURE OF INTRA-GROUP LOANS

B.9.3.2.1. In accordance with what was discussed in chapter 9.2.1 supra, the first step of analysis is the identification of the commercial or financial relations between the associated enterprises by analysing the economically relevant characteristics (or comparability factors) of a transaction in order to accurately delineate the actual transaction undertaken. In the specific case of intra-group loans, it will be necessary to analyse economically relevant characteristics (or comparability factors). Some examples of economically significant characteristics include:

- The contractual terms of the tested loan (e.g., the type of loan, tenure – i.e., time to maturity – of the loan, the obligation to pay (by way of a bullet payment at the end of the term or by way of fixed amounts throughout the term of the loan) and type of interest rate (e.g. contingent on profits, variable or fixed)), currency used, embedded options such as the right to convert the loan into equity or right to extend the term of the loan or prematurely terminate and repay the loan, seniority of the loan, subordination of the creditor as compared to other creditors that are granted superior rights, collateral, security and guarantees provided to the creditor that the nominal amount of the loan will be repaid, repayment schedule (e.g. fixed amounts, or payments contingent on having net profit available). In some cases, certain relevant characteristics may not be included in the contractual agreement, and it may be necessary to refer to other documents and to the conduct of the parties to accurately delineate the terms of the loan.
- The functions performed, assets used, and risks assumed by both the borrower and the lender, considering the purpose of the loan and any interaction with other intra-group transactions. This functional analysis considers the perspectives of both borrower and lender and involves e.g. an assessment of the debt capacity and credit risk of the borrower including the risks stemming from the financial instrument-specific credit rating. The conduct of the parties should also be examined. Where such conduct does not align with the contractual terms, the former may need to be prioritized.
- The economic circumstances of both the borrower and the lender and of the industries and market in which they operate, including circumstances which have a bearing on the type of funding available, but also the ability of the borrower to obtain loan financing/funding through other means from other (third) parties and the purpose of the funding.

- The business strategies pursued by the borrower and lender, including financing policies and debt targets.

B.9.3.2.2. At this point, the accurate delineation process will have identified the economically significant features of the transaction that will be necessary to consider in pricing the loan. The accurately delineated loan transaction subsequently needs to be priced in accordance with the arm's length principle. The economically relevant characteristics that have been identified are relevant in comparing the controlled transaction with uncontrolled transactions that share comparable characteristics.

[Possibly examples to be inserted]

B.9.3.2.3. Once the transaction has been accurately delineated, the next step of the analysis would be the selection and application of the most appropriate transfer pricing method. As the main compensation generated by an intra-group loan is the interest payment, the arm's length interest must be determined. However, it should be considered that certain other elements might also be compensated separately (e.g. fees).

B.9.3.2.4. To determine the interest rate of an intercompany loan, the CUP method is usually applied. This means that reference is made to interest rates that are negotiated and agreed upon by independent entities for transactions comparable to the transaction under review. The CUP method could be applied in the following ways:

- Internal CUP method: interest rates applied to similar transactions in similar circumstances between one of the tested parties and an unrelated entity.
- External CUP method: either interest rates applied to similar transactions in similar circumstances between unrelated entities or use of interest rates based on those published in public databases for similar debt instruments.
- In case simplification measures are in place, or an approach applies that is similar to the "sixth method" approach: application thereof (see B.9.3.2.8.).

[Possibly examples to be inserted]

B.9.3.2.5. When using an external CUP method, the information deriving from third party (syndicated) loans and bonds and other information contained in publicly available databases may be beneficial. Comparable uncontrolled interest rates for borrowers with a range of credit ratings can be accessed through databases made available by professional commercial data vendors.¹³ These databases provide information on interest rates for loans and bonds of third parties considering different credit ratings (examples of which are listed in paragraph B.9.2.2.2.) and conditions, such as terms of securities, time-period for which the financing is made available, currency, and dates at which the loans and bonds are entered into.

¹³ Reference can be made for example to Bloomberg, Loan Connector, Reuters and S&P.

B.9.3.2.6. When applying the CUP method, it will be essential to verify that all the economically relevant characteristics (or comparability factors) illustrated before that have a material effect on the interest rate are taken into account; hence, the resulting interest rate might also need to be adapted by means of comparability adjustments in order to reflect such factors, as long as such adjustment can be made reliably.

B.9.3.2.7. Apart from the CUP method, as mentioned before, a cost-based method could possibly be applied in some cases (e.g., in cases of on-lending whereby an entity of a group obtains financing from an unrelated entity and provides the resources obtained to a related entity, i.e. “pass-through” scenarios). In essence the intercompany loan is priced based on the cost of funds incurred by the lender who is raising the funds to lend, together with the expenses of arranging the loan and the relevant costs incurred in servicing the loan, a risk premium to reflect the various economic factors inherent in the proposed loan, plus a profit margin.¹⁴ While applying this method to price the intercompany loan, the lender’s cost of funds relative to other lenders in the market may also need to be considered. A lender in a competitive market would probably seek to price at the lowest possible rate to win business. A borrower, likewise, would probably seek to borrow at the lowest rate available to it in the market. As with other methods, this method also requires consideration of options realistically available to the borrower, who would enter into this transaction only if there is no better alternative available.

B.9.3.2.8. Some countries apply a simplification rule for determining the interest rate for loans that resembles the “sixth method” that is discussed in Chapter B.3.4.2. (in this regard, the comparable transaction interest rate could be the interest rate for international public bonds such as the US bonds, or the London InterBank Offered Rate (LIBOR) or even the interest rate of bonds issued by the country where the company making the loan is resident or where the loan is negotiated based on the country's currency). These rates may work as proxies for interest rates of financial transactions between unrelated parties that may or may not be subject to appropriate adjustments for specific situations. The outcome of this approach provides a similar advantage as does the sixth method rule for commodities, that’s to say it eliminates the need for a comparable transaction.¹⁵

B.9.3.2.9. Other relevant information in determining an arm’s length interest rate for intra-group loans may include the use of Credit Default Swaps to reflect the credit risk linked to an underlying financial asset, Economic Modelling by constructing an interest rate as a proxy.

B.9.3.2.10. The arm’s length pricing of intra-group loans may also involve the evaluation of fees and other charges in relation to intra-group loans. It may need to be considered however, that associated enterprises may not incur charges similar to those that independent lenders (i.e. banks) would in the process of raising capital and satisfying regulatory requirements.

B.9.3.3. Interplay between intra-group loans and other intra-group transactions

B.9.3.3.1. The previous section discussed the pricing of intra-group loans, but the opening section of this guidance pointed out the importance of considering the interplay between intra-

¹⁴ See also Paragraphs 89-91 of the OECD Discussion Draft.

¹⁵ Brazil currently applies this methodology – see Subpart D.1.8.4 of the 2017 UN Manual, p. 542-543.

group loans and other intra-group transactions. This is because financing arrangements and the commercial purposes of funding can be a pointer in identifying the functions and economic circumstances of the MNE and in delineating other intra-group transactions for the transfer of property or services that may be supported by the financing arrangements. Even though the intra-group financial transaction under review may be accurately delineated and the interest rate for that separate intra-group financial transaction may be at arm's length, the existence of the intra-group financial transaction may point to economically significant characteristics of the associated enterprises that help to improve reliability of comparisons for the purposes of evaluating those other intra-group transactions.

[Possibly examples to be inserted]

B.9.4. THE APPLICATION OF THE ARM'S LENGTH PRINCIPLE TO INTRA-GROUP FINANCIAL GUARANTEES

B.9.4.1. DIFFERENT TYPES OF INTRA-GROUP FINANCIAL GUARANTEES AND RELEVANT CHARACTERISTICS TO CONSIDER

B.9.4.1.1. With an intra-group financial guarantee, one related party (the guarantor) agrees to assume the financial obligations (deriving from the guaranteed instrument) of another related party (the guaranteed entity) towards a lender in the event that the guaranteed entity defaults on its obligations towards this lender. As a result, the risk exposure of the lender is generally reduced. With an intra-group financial guarantee, the guaranteed entity may be able to obtain advantageous conditions (such as a lower interest rate) from the lender. However, it needs to be determined if the guarantor will provide the guarantee and assume the credit risk related to the guaranteed instrument in return for an arm's length payment, i.e., a guarantee fee. Sometimes no guarantee fee will apply at arm's length. To determine if arm's length compensation is required for a financial guarantee, all of the relevant terms and conditions of the guarantee should be considered and supported by the conduct of the parties.

B.9.4.1.2. Although the concept of financial guarantees may appear relatively straightforward, they merit closer review and some financial guarantees can be structured or operate in extremely complex ways. To determine the arm's length remuneration for a financial guarantee, a closer look and accurate delineation will be a necessary step. In practice, many different types of intra-group financial guarantees exist, for example:

- Explicit credit guarantees: a legally binding commitment provided, in most cases, by the parent company to a company belonging to the group which states that the former will pay to a third-party financing entity the amount that was lent to the latter in the event that the latter cannot fulfil its obligations. Three types of explicit guarantees are commonly used:

- Downstream guarantees: the parent company issues a guarantee to external creditors for the benefit of one of its subsidiaries so that the latter can enter into agreements with external creditors (typically used in decentralized business structures or when the location of the subsidiary is more attractive for obtaining external financing).
- Upstream guarantees: a group company issues a guarantee to external creditors for the benefit of its parent company so that the latter can enter into agreements with the external creditors (typically used when the external financing is obtained at a parent or holding level or when the parent company performs central treasury functions).
- Cross guarantees: Several group companies issue guarantees to external creditors for the benefit of each other so that they can all be considered as one single legal obligor (typically used in cash pooling).

B.9.4.1.3. Mention can also be made of comfort letters/letters of intent¹⁶ and keep-well agreements¹⁷, but these generally do not transfer risk and generally are not considered as financial guarantees that require an arm's length payment.

B.9.4.1.4. A particular issue also in the field of intercompany financial guarantees in MNE context is the concept of 'implicit support': a lender may be willing to accept conditions for a loan granted to a borrower under the assumption that the parent company of the borrower will step in and meet the obligations of the borrower, in case the latter cannot perform under the loan, *without* having received any legally binding confirmation to that extent from the parent company. In that case, the lender is merely assuming that there is a possibility that the parent company will assume the obligations of its associated enterprise/the borrower. Implicit support involves no explicit assumption of risk by the parent company deemed to be the guarantor and no explicit right for the lender to ask the parent company to assume the obligations of the borrower in case the latter defaults.

B.9.4.1.5. The first issue in considering a financial guarantee is the extent to which there is implicit support, if any as well as its. If there is no enforceable right for either the lender or the borrower to force the parent company to assume the risk of the lender it can be expected that a(n) (independent) borrower would not be willing to pay for the implicit support. Nevertheless, just by being a member of the MNE group, the borrower may be able to obtain more favourable financing terms than it would have obtained on a stand-alone basis. The impact of implicit support is that the risk that the subsidiary of an MNE Group defaults is perceived to be less than if it were truly a stand-alone borrower. From the perspective of the lender, the overall credit risk for the loan is the (-usually- better) rating of the MNE Group or that of the parent company.

¹⁶ These include a promise (i.e., generally, not legally binding) provided, in most cases, by the parent company to a company belonging to the group which states that the former will oversee the latter's affairs in order to be in accordance with the group strategies and rules and refrain from taking adverse actions that would compromise the financial stability of another group company.

¹⁷ These include a declaration provided, in most cases, by the parent company to a company belonging to the group which states that the former will provide the latter with additional capital to prevent the risk of its default.

B.9.4.2. DETERMINING THE ARM'S LENGTH NATURE OF INTRA-GROUP FINANCIAL GUARANTEES

B.9.4.2.1. To determine the arm's length nature of (the fee for) an explicit financial guarantee, the following economically relevant characteristics (or comparability factors) should be considered:

- The contractual terms of the financial guarantee (including terms and conditions of the guaranteed instrument), as supported by the conduct of the parties;
- The risk profile of the borrower also accounting for the possible impact of implicit support), by considering the functions performed, and assets used by the guaranteed entity (including any available external credit rating of the borrower and of the guaranteed instrument as well as the probability of default of the borrower);
- The risk profile and financial capacity of the guarantor;
- The characteristics of the financial guarantee (including benefits provided by the financial guarantee, if any);
- The economic circumstances of both the guarantor and the guaranteed entity and of the market in which they operate;
- The business strategies pursued by the guarantor and guaranteed entity.

B.9.4.2.2. Moreover, all the terms and conditions established in the financial guarantee should reflect the accurately delineated transaction that has been undertaken and supported by the conduct of the parties.

B.9.4.2.3. An assessment is requirement of the underlying reason for the financial guarantee and whether there is indeed any benefit created by it, typically implying an analysis of the form of the financial guarantee, the purpose of the financial guarantee, the willingness of the guarantor to provide support to the guaranteed entity, and the request by the third party to provide the financial guarantee, so that it is clear what obligation of the borrower is transferred to the guarantor and under what conditions will the guarantee be triggered.

B.9.4.2.4. An intra-group financial guarantee will have commercial value if:

- Obligations of the borrower have been transferred to the guarantor under circumstances defined in the financial guarantee;
- An independent party would be willing to pay for the intra-group financial guarantee;
- The guaranteed entity/borrower achieves a better (lower) price for the intra-group loan because of the intra-group financial guarantee.

B.9.4.2.5. On the contrary, the deductibility of an intra-group financial guarantee could be challenged or will probably not be chargeable to the extent:

- The guaranteed entity is perceived as having a better creditworthiness only because of its group affiliation (so-called 'implicit support').
- When the debtor has no debt capacity or credit status and, therefore, would not be able to access the capital market without the financial guarantee. In essence, a third party would

never provide a loan to this debtor absent an intercompany guarantee for example due to its insufficient debt capacity. In situations like this, a guarantee by the parent company might be considered as some form of shareholder function performed in its own interest or alternatively the parent company providing the guarantee essentially and substantively can be seen as having become the borrower.¹⁸

- The financial guarantee has been requested by the creditor only to avoid that the parent company diverts the funds of the financed company, i.e., moral hazard issues (although in this situation there may be benefit for the debtor because of obtaining a better credit rating).

[Possibly examples to be inserted]

B.9.4.2.6. The next step of the transfer pricing analysis would be the selection and application of the most appropriate transfer pricing method. The most common form of compensation for an intra-group financial guarantee is a guarantee fee. Therefore, the arm's length compensation for a guarantee fee could be determined by reference to guarantee fees that unrelated entities have agreed upon (or would agree upon) for similar transactions in similar circumstances. A guarantee fee considers the debtor's probability of default; the amount guaranteed by the guarantor; and the guarantor's cost of capital (consisting of the need to lock-up of capital due to the potential risk to have to pay the guarantee fee and not being able to use that amount in another fashion), plus the impact of implicit support, if any, and the benefit resulting from the guarantee for the borrower. See also B.9.4.2.4. supra.

B.9.4.2.7. The CUP method may also be applied, if comparable uncontrolled transactions in comparable circumstances can be identified. The CUP method can be applied in the following ways:

- Internal CUP method: (the amount to be paid for) guarantee fees applied to similar transactions in similar circumstances between the associated enterprise and an unrelated entity.
- External CUP: This is more theoretical, as comparables are very hard to obtain. If available, they would consist of (research of) guarantee fees applied to similar transactions in similar circumstances between unrelated entities.

[Possibly examples to be inserted]

B.9.4.2.8. When applying the CUP method, the information deriving from third party financial guarantees, bankers' acceptances, credit default swap fees, letter of credit fees, commitment fees, various types of insurance, and put options may be beneficial. Furthermore, it will be essential to verify that all the economically relevant characteristics (or comparability factors) illustrated before are considered; hence, the resulting guarantee fee might also need to be adjusted by means of comparability adjustments to reflect such factors.

¹⁸ E.g., the accurate delineation of the transaction could suggest that the transaction is not a guarantee arrangement at all, but that the purported guarantor is in fact the direct borrower.

B.9.4.2.9. Other (more often used) approaches to calculate a guarantee fee include:

- Yield approach: analysis from the perspective of the guarantor and the guaranteed entity which will determine the benefit received from the guarantee. The yield approach is meant to estimate the maximum potential interest rate savings achieved by the borrowing entity because of the explicit guarantee. This approach calculates the spread between the interest rate that would have been payable by the borrower without the guarantee and the interest rate actually payable by the guaranteed borrower. To determine the first element, the interest costs are calculated for the borrower as if it were to take on the guaranteed loan on its own merit (but with inclusion of implicit support). Reference can be made to Section B.9.2.2. in this respect. The benefit to be priced is the difference between the cost of the borrower after taking into account the implicit support and the cost of the borrower with the benefit of the explicit guarantee. The benefit of the saved interest is to be divided among the guarantor and borrower as the borrower otherwise would not have any incentive to obtain the corporate guarantee. This approach (sometimes also referenced as yield approach), is accepted by various taxing authorities and judicial bodies.
- A cost approach can be considered to calculate a (minimum) guarantee fee. It quantifies the additional risk borne by the guarantor/considering the value of the expected loss that the guarantor would incur by providing the guarantee:

What is the capital required to support the risks of the guarantor? This can be approximated provided careful consideration is applied, through (i) a Credit default swap model: the value of the financial guarantee is determined as a proxy of credit default swap fees; through (ii) a Contingent put option: the value of the price that the guaranteed entity should pay for a hypothetical right to sell the guaranteed instrument to the guarantor at a specified price (i.e., face value) and under certain circumstances (i.e., credit event) (otherwise stated, a put option on the guaranteed instrument) would provide the measure of the arm's length amount of the guarantee fees; through (iii) a Cost of capital analysis: the arm's length amount of the guarantee fees will be determined by referencing the cost of capital that the guaranteed entity would - hypothetically- need to pay to increase its equity enough to achieve the same level of creditworthiness as it has with the guarantee of the guarantor in place; through (iv) Financial guarantee insurance: the value of the financial guarantee will be determined by analysing financial guarantee insurance premiums; or perhaps by approximation.

[Possibly examples to be inserted]

ATTACHMENT B: PROPOSED TEXT FOR REVISED CHAPTER B.2. COMPARABILITY ANALYSIS

Note: Changes from the existing text of the UN Practical Manual on Transfer Pricing for Developing Countries (2017) are shown in mark-up.

B.2.1 Rationale for comparability analysis

1. [B.2.1.1.] The term “comparability analysis” is used to designate two distinct but related analytical steps:
 - (1) An understanding of the accurately delineated transaction, which includes
 - a. The economically significant characteristics and circumstances of the controlled transaction, i.e. the transaction between associated enterprises, and
 - b. The respective roles and responsibilities of the parties to the controlled transaction. This is generally considered as part of the functional analysis, see further para. B.2.3.2.8.
 - (2) A comparison between the conditions of the controlled transaction (as established in step 1 immediately above) and those in uncontrolled transactions (i.e. transactions between independent enterprises) taking place in comparable circumstances. The latter are often referred to as “comparable uncontrolled transactions” or “comparables”.
2. [B.2.1.2.] This concept of comparability analysis is used in the selection of the most appropriate transfer pricing method, as well as in applying the selected method to arrive at an arm’s length price or financial indicator (or range of prices or financial indicators). It thus plays a central role in the overall application of the arm’s length principle.
3. [B.2.1.3.] A practical difficulty in applying the arm’s length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Where independent enterprises do not undertake transactions of the type entered into by associated enterprises, the arm’s length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises. The mere fact that a transaction may not be found between independent parties does not of itself mean that it is, or is not, arm’s length.
4. [B.2.1.4.] It should be kept in mind that the relative lack of comparables for a taxpayer’s controlled transaction does not imply that the arm’s length principle is inapplicable to that transaction. Nor does it imply anything about whether that transaction is or is not, in fact, at arm’s length. In a number of instances, it will be possible to use “imperfect” comparables, e.g. comparables from another country with comparable economic conditions or comparables from another industry sector. Such comparables may need to be adjusted to eliminate or reduce the differences between that transaction and the controlled transaction as discussed in paragraph B.2.1.5. below, provided such adjustments can be done reliably. In other instances, where no comparables are found for a controlled transaction between associated enterprises, it may become necessary to use approaches not depending directly on

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comparables to find an arm's length price³⁵ (see further Chapter B.3.). It may also be necessary to examine the economic substance of the controlled transaction to determine whether its conditions are such that it might be expected to have been agreed between independent parties in similar circumstances— in the absence of evidence of what independent parties have actually done in similar circumstances.

35 [FOOTNOTE] The Platform for Collaboration on Tax has published *A Toolkit for Addressing Difficulties in Accessing Comparable Data for Transfer Pricing Analyses*, available from <https://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf> . This toolkit sets out in greater detail a number of strategies designed to address the issue of a lack of comparables data.

5. [B.2.1.5.] A controlled and an uncontrolled transaction are regarded as comparable if the economically relevant characteristics of the two transactions and the circumstances surrounding them are sufficiently similar to provide a reliable measure of an arm's length result. It is recognized that in reality two transactions are seldom completely alike and in this imperfect world, perfect comparables are often not available. It is therefore necessary to use a practical approach to establish the degree of comparability between controlled and uncontrolled transactions. To be comparable does not mean that the two transactions are necessarily identical, but instead means that either none of the differences between them could materially affect the arm's length price or profit or, where such material differences exist, that reasonably accurate adjustments can be made to eliminate their effect. Thus, in determining a reasonable degree of comparability, adjustments may need to be made to account for certain material differences between the controlled and uncontrolled transactions. These adjustments (which are referred to as "comparability adjustments") are to be made only if the effect of the material differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results.
6. [B.2.1.9.] Practical guidance is needed for cases without sufficient comparables. There seem to be two distinct problems relating to comparables for developing countries' tax authorities. The first is lack of access to existing sources, such as existing non-local company databases; the second is the lack of reliable local country comparables. For each of these, there are problems associated with both administration (e.g. how the lack of data impedes the reliable and efficient determination of appropriate arm's length results) and problems associated with double tax/dispute avoidance (e.g. how the lack of appropriate data impedes a developing country's ability to reach agreement with other tax authorities, or prevent the developing country from being taken advantage of).
7. [New, replacing B.2.1.10] In the process of undertaking a transfer pricing analysis, the first step always involves the accurate delineation of the transaction, including an awareness of the industry and market context in which the transaction takes place. From this, the most appropriate transfer pricing method can be selected (bearing in mind the likely existence of necessary data) and where appropriate, a tested party will be chosen. This process should determine what kind of comparables should be sought. Where such comparables operating in the same jurisdiction as the tested party are available there is no need to consider whether geographic differences might have a material impact on the prices or profits under review. However, in the absence of such information, foreign comparables should not automatically be rejected as all transfer pricing cases require a solution. A pragmatic approach, making use of the best available comparables will often be required. Adjustments may need to be considered and made where they improve the reliability of the comparison.

~~B.2.1.10. The OECD Transfer Pricing Guidelines point out that non-domestic comparables should not be automatically rejected. The Guidelines further recommend that where independent transactions are scarce in certain markets and industries a pragmatic solution needs to be found on a case-by-case basis. 35 This~~

~~means that when the data are insufficient, stakeholders can still use imperfect comparables, after necessary adjustments are made, to assess the arm's length price. The validity of such procedures depends heavily on the accuracy of the comparability analysis as a whole.~~

8. [B.2.1.11.] This chapter discusses a possible procedure to identify, screen, select and adjust comparables in a manner that enables the taxpayer or tax administration to make an informed choice of the most appropriate transfer pricing method and apply that method correctly to arrive at the appropriate arm's length price or profit (or range of prices or profits).

B.2.2 Comparability analysis process

[as is]

B.2.3 Comparability analysis in operation

[as is]

B.2.3.1 Understanding the economically significant characteristics of the industry, business and controlled transactions

[as is]

B.2.3.2 Examination of economically significant characteristics of the controlled transaction

[as is]

B.2.3.3 Selection of the tested party

[as is]

B.2.3.4 Identification of potentially comparable transactions or companies

9. [B.2.3.4.1.] Comparable uncontrolled transactions (“comparables”) are of two types:
- Internal comparables, i.e. transactions between one of the parties to the controlled transaction (taxpayer or foreign associated enterprise) and an independent party; or
 - **Third-party** or external comparables, i.e. comparable uncontrolled transactions between two independent parties, neither of which is a party to the controlled transaction.

Internal comparables

[as is]

Third-party comparable/external comparable

10. [B.2.3.4.7.] There are two types of third party or external comparable. The first type relates to transactions between two independent parties, neither of which is a party to the controlled transaction.

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For example, it might be possible to apply the CUP Method based on the price of a comparable product sold under comparable circumstances by uncontrolled parties.

11. [New] The second type of external comparable relates to the use of the results of comparable uncontrolled companies (engaged in comparable transactions) when applying profit-based transfer pricing methods. Typically, such results are identified through the use of commercial databases and the application of “screening” criteria. The determination of appropriate screening criteria is a critical step and should be based on the most economically relevant characteristics of the accurately delineated controlled transaction [insert cross reference to comparability factors]. The objective of finding the closest comparables must, however, also be balanced with the need to be pragmatic and to find an answer.

~~[B.2.3.4.8 The second type of third party or uncontrolled comparable relates to comparable uncontrolled companies, for example in the application of profit based methods. The identification and selection of these reliable external comparables can be executed in a five step process:~~

- ~~(1) Examination of the five comparability factors for the controlled transaction;~~
- ~~(2) Development of comparable search or “screening” criteria;~~
- ~~(3) Approach to identifying potential comparables;~~
- ~~(4) Initial identification and screening of comparables; and~~
- ~~(5) Secondary screening, verification and selection of comparable.]~~

~~B.2.3.4.9. An illustration of how such a process can be performed follows; it is applicable especially in cases where external comparables are extracted from a database.~~

Sources of Information for External Comparables

11. [B.2.3.4.36.] There are various sources of data and information which are available to assist a taxpayer or tax administration in identifying potential **external** comparables. Possible sources range from **commercial or** electronic databases to regulatory and other government filings and various analytical reports issued by trade and industry associations. The search objective is to identify the most reliable comparables for the controlled transaction under examination according to the specific set of criteria.
12. [B.2.3.4.37.] The data sources provide a vast array of information. Some provide simple leads or contacts, or a starting point to learn more about a particular industry so that appropriate comparables are ultimately selected. Others provide business profiles and detailed financial information about potential comparables. Each source can be important in establishing and documenting the quantitative basis for an arm’s length transfer pricing policy.
13. [B.2.3.4.38.] A key resource among the general sources of information is that of **commercial** databases **including in electronic form**. These databases have been developed by various organizations which compile accounts filed by companies with the relevant administrative bodies and present them in an electronic format suitable for searches and statistical analysis. Some of these databases compile financial data from one country only, while others compile regional or even global data. These products typically provide detailed financial information as well as some textual information such as short business descriptions, although the level of detail largely depends on the country concerned.
14. [B.2.3.4.39.] The advantage of **commercial** databases is that they can provide the ability to sort quickly and retrieve selectively only the potential comparables that meet certain qualitative and quantitative screening criteria. Criteria commonly used for initial screening include industry codes, scale or sales volume, ownership and related/associated enterprises, availability of financial data or certain financial ratios.

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15. [B.2.3.4.41.] It is important to note that **commercial** databases rely on publicly available information. These databases may not be available in all countries, since not all countries have the same amount of publicly available information about their companies. Further, due to the different disclosure and filing requirements depending on the legal form of the enterprise, the information may not be in a similar format, making it difficult to compare. Most of these databases are used to compare the results of companies rather than of transactions because third party transactional information is generally not readily available.
16. [B.2.3.4.42.] Commercial databases can be a practical and sometimes cost-effective way of identifying external comparables and may provide the most reliable source of information, depending on the facts and circumstances of the case. However, a number of limitations to commercial databases are frequently identified and commercial databases are not available in all countries. Further, they may be costly to use and many developing countries may not have access to them. The use of commercial databases is not compulsory, and it may be possible to identify reliable comparables from other sources of information, including internal comparables as described above, or a manual identification of third parties (such as competitors) that are regarded as potential sources of comparables for the taxpayer's controlled transaction.
17. [New] In addition to information from commercial databases of company results, a number of other sources of information may be useful, including in some cases, price databases, publications and exchange quoted prices for commodities. Such publications may provide useful information on market conditions and prices of standard commodities. They can also be useful in understanding relevant market dynamics for the products concerned. In some cases, it may be appropriate to use quoted prices from commodities or futures exchanges in order to benchmark transfer prices for commodities. *[Insert cross reference to section on 6th method]* However, as with any such source of potential benchmarking data, its reliability in pricing the tested transaction must be carefully considered, particularly in the case of information in relation to less transparent markets, i.e. those in which information on individual transactions is not generally available to those who are not a party to the transaction. In such cases, the published information will typically be based on the publisher's observations and contacts with key market participants. While this kind of information can be useful, it should be borne in mind that the publisher may have made adjustments to the raw data in ways that may not be apparent. Such data should therefore be used with care.
18. [B.2.3.4.43] Other sources of comparable data may include the following:
- Government sources—many governments and regulatory agencies maintain databases on several industries. Such sources can be located on the agency's Internet websites;
 - Trade institutions and organizations—often these institutions or organizations will maintain databases and research reports, and/or hold files with data on potential comparables. Generally, these institutions or organizations would be:
 - Chambers of commerce;
 - Trade and professional organizations;
 - Embassies, consulates or trade missions; or
 - International organizations (e.g. the United Nations, the Organisation for Economic Co-operation and Development, the World Bank, the International Monetary Fund).
 - ~~Taxpayer or~~ Other sources of knowledge on competitors or other entities which may make suitable comparables

Approach to identifying potential comparables [MOVED to follow 2.3.4.8]

19. [B.2.3.4.25.] In identifying potentially comparable uncontrolled transactions or enterprises two approaches are possible: the “additive” and the “deductive”.
20. [B.2.3.4.26.] In the additive approach a list is prepared of potentially comparable uncontrolled transactions or of third parties which are believed to be carrying out potentially comparable transactions. As much information as possible on these transactions is then collected to confirm whether they are in effect acceptable comparables, based on the economically relevant characteristics for the controlled transaction. When adopting the additive approach special care should be taken in order to provide a reliable comparable; it is not sufficient that a third-party company be well-known in the relevant industrial sector. Also, one needs to avoid potential third party companies who themselves have transfer pricing issues.
21. [B.2.3.4.27.] The deductive approach usually commences with a search on a database for comparable companies or transactions. These can be commercial databases developed by editors who compile accounts filed by companies with the relevant governmental authorities, or proprietary databases developed by advisory firms. The approach typically starts with a wide set of companies that operate in the same sector of activity, perform similar broad functions, and do not present economic characteristics that are obviously different.
22. [B.2.3.4.28.] It should be emphasized that the exclusive use of either of the two approaches may not yield valuable results. Depending on the facts of each case, one of the above two approaches can be used or both in combination.
23. [B.2.3.4.29.] It is possible that companies identified using the additive approach may not have been identified when using the deductive approach. This may in some cases suggest that the search strategy applied under the deductive approach is not sufficiently robust and should be reassessed, or simply that certain information is not contained in the database selected. Therefore, the additive approach could be useful for assessing whether the deductive search strategy is reliable, comprehensive and appropriate given the economic characteristics being considered.
24. [B.2.3.4.30.] It is very important that the taxpayer or tax administration using the “additive” and/or “deductive” approaches justifies and documents the criteria used to include or exclude particular third-party data from the pool of potential comparables, in order to ensure a reasonable degree of objectivity and transparency in the process. In particular, the process should be reproducible by the taxpayer and by the tax administration that wishes to assess it. It is also very important that third party data be refined using qualitative criteria. It would be improper to use financial information relating to the transactions of a large sample of companies that have been selected solely because they are classified in a database under a given industry code.

Deductive approach: initial identification and screening of comparables

25. [B.2.3.4.31.] The next step, after having developed a set of comparability criteria that are tailored to the specifics of the controlled transaction at issue, is to conduct an initial identification and screening of potential independent comparables. The objective in this initial screening, where performed using a commercial database, is to identify substantially all companies that have a reasonable probability of demonstrating the threshold comparability requirements and of providing verifiable, objective documentary evidence of market pricing or profits. In other words, the desired initial result is to obtain the largest possible pool of potential independent comparables for subsequent screening, verification, and analysis. Where comparables are selected from information sources other than databases this part of the process may be different.

ATTACHMENT B: COMPARABILITY ANALYSIS

26. [B.2.3.4.32.] The process of screening, verification and selection of comparables will largely depend upon the availability of databases in the public domain in the country. Public databases may be available in some countries whereas other countries may not have these databases. In such cases, one of the options could be to rely on a database from a comparable economy with reasonable and reliable adjustments.
27. [B.2.3.4.33.] The following analytical needs and constraints should, however, be kept in mind:
- The search process should avoid any systematic biases;
 - The screening process must be executed and documented in a manner consistent with the general requirement for due diligence; and
 - It should be recognized that some of the initial comparables will be eliminated in subsequent stages of screening and analysis

~~Secondary screening, verification and selection~~

~~B.2.3.4.34. Under this step, the search process focuses on a rigorous review of each transaction or company in the potential independent comparable pool against the full range of specific screening criteria. The objectives at this stage are verification, final screening and selection. This process is based on trial and error and requires multiple data sources, cross checks and selected follow up and confirmation of factual data.~~

28. [B.2.3.4.35.] The person performing the search for comparables may have to use a variety of information sources for third party or external comparables. These can include company-specific information sources including annual reports, regulatory and other government filings, product literature and securities analyst reports, as well as various trade and industry association materials. Once intermediate screening has been completed a complete set of company financial statement data should be generated and reviewed for adequacy, period coverage and general consistency. Sometimes details may even be obtained through telephone or personal interviews with company management and it is also possible to use the knowledge of internal operating personnel to identify comparables. For example, sales and marketing personnel can be asked to assist in identifying independent third-party resellers whose financial statements may be used as a basis for establishing comparable profit margins.
29. [B.2.3.4.36.] There are various sources of data and information which are available to assist a taxpayer or tax administration in identifying potential comparables. Possible sources range from electronic databases to regulatory and other government filings and various analytical reports issued by trade and industry associations. The search objective is to identify the most reliable comparables for the controlled transaction under examination according to the specific set of criteria.

[Paragraphs B.2.3.4.37. to B.2.3.4.42 moved above]

[Paragraph B.2.3.4.43 moved above]

Examination of the economically relevant characteristics of the transaction

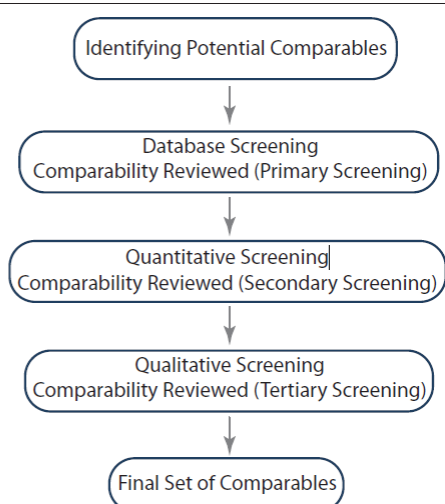
30. [New] Examination of the economically relevant characteristics of the accurately delineated controlled transaction will help in the selection of the most appropriate transfer pricing method and in developing search criteria to identify reliable comparables with which to apply the selected method.

Development of comparable search or “screening” criteria

31. [B.2.3.4.11.] Comparable search or “screening” criteria are developed based upon the results of the above-mentioned examination of the economically relevant characteristics in relation to the controlled transaction. These criteria must be defined so as to identify those external uncontrolled transactions that satisfy comparability *vis-à-vis* the controlled transaction and the tested party. The search criteria should be set so as to select the most reliable comparables. At the same time, the initial search criteria should not be overly restrictive, in order not to set unrealistic expectations in terms of comparability. Once potential comparables have been selected comparability adjustments should be considered, and in cases where they improve the reliability of the comparison, they should be made. **The selection of the most appropriate transfer pricing method will primarily be driven by the nature of the accurately delineated transaction, but of course, the availability of reliable comparables will influence the choice.**
32. [B.2.3.4.12.] A typical process of comparable searching may be divided into three screening phases, namely (i) database screening (primary screening), (ii) quantitative screening (secondary screening) and (iii) qualitative screening (tertiary screening). Potential comparables are reviewed in each of these phases to determine whether they qualify as comparables.:

Figure B.2.1:

A Typical Screening Process



Database Screening (Primary Screening)

33. [New] The determination of appropriate screening criteria will depend on the most economically relevant characteristics of the accurately delineated transaction. Typically, they will begin with the industry code and include screens to ensure the transactions engaged in by the potential comparables are indeed comparable and uncontrolled, and that sufficient financial information is available and can be relied upon. While screens based on industry codes and geographic market are commonly applied, it is always important to consider what characteristics are most economically relevant to the accurately delineated tested transaction(s). For instance, functional comparability may be more important than similarity of industry or market. In such cases, indiscriminate application of the less relevant criteria may be unhelpful, resulting in no comparables being left with which to apply the transfer pricing method.

34. [New] Information derived from external comparables should reflect the economic environment at the time the controlled transaction was undertaken. In principle, information from external comparables contemporaneous with the controlled transaction might be expected to reflect the same economic environment, but there can be practical difficulties in obtaining contemporaneous information given the time required for such information to be prepared, reported, and uploaded on to databases. For a discussion on timing issues, see section B.2.4.2.
35. [B.2.3.4.20.] Examining multiple year data may be useful in a comparability analysis but it is not a systematic requirement. Multiple year data may be used where they add value and make the transfer pricing analysis more reliable. Circumstances that may warrant consideration of data from multiple years include the effect of business cycles in the taxpayer's industry or the effects of life cycles for a particular product or intangible. However, the existence of any such cycle needs to be aptly demonstrated by the taxpayer.

Box – Example of a typical process of database screening – reviewing comparability¹

The process described in this box is simply an example of a commonly-used approach to conducting a database search for comparables. In any particular case, however, consideration should be given to the most economically significant characteristics of the accurately delineated transaction under review as the basis for determining appropriate screening criteria. For instance, it may be unhelpful to eliminate potential comparables from other markets where geographic or market similarity is not in fact critical to the prices or profits associated with the transaction under review.

1 Industry/business activity qualification codes

A common starting point in the comparables search process is industry/business activity classification codes. Countries may have a set of industry classification codes used for statistical or other purposes. Alternatively, Standard Industry Classification codes (SIC) the Nomenclature of Economic Activities in the European Community (NACE), and the North American Industry Classification System (NAICS) industry codes are the most commonly used by taxpayers and tax administrations worldwide.

This screen will typically also enable a focus on the appropriate level of the market.

2 Geography/region/country/market

It generally makes sense to consider potential comparables from the same geographic market as the tested party in the first instance as this will minimise any potential differences that could have a material effect on the comparison. However, in many countries, especially developing countries, the availability of independent comparables, or of public information on independent comparables, is limited. Where there is no information available relating to transactions that are in other respects comparable to the tested transaction and relate to the same geographic market, it is important to consider the relative importance of the various comparability factors, bearing in mind that the aim is to find the most reliable comparables available. That is, other comparability factors such as those relating to the functional analysis may be more important in a particular case than the geographic market, in which case, this screening criterion could be demoted or even abolished. Where the market is considered to be a key comparability factor, it may be appropriate for this to be defined as a country, a region, or group of countries that are considered to be

¹ The information in this box is adapted from the Platform for Collaboration on Tax publication, A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses, Box 7, p.43

either (a) a single or largely integrated market; or (b) sufficiently similar to the market of the tested transactions.

3 Key words related to the business activity

This stage generally involves identifying and searching for key terms related to the tested party's business and the activities associated with the transactions under review. For example, key words may relate to the most important activities and the level of market.

4 Availability of financial information

For practical reasons, potential results are screened out if information in relation to the relevant years are missing. In the event that multiple year data is being used, it may be pragmatic to screen out potential results with two or more years of information missing.

5 Level of revenues (or other indicators of size, such as assets or number of employees)

In some cases, the magnitude of the business can have a material effect on comparability. If so, it can be relevant to include a screen based on the size of the potential comparables, as measured by, for instance, turnover, asset values, employees, etc. In addition, it may be appropriate in some cases to examine more carefully any companies with continuous losses. At arm's length, independent companies may make losses, but this would not be expected to continue for an extended period of time.

6 Independence, public vs privately held companies

A fundamental element of the arm's length principle is that of a comparison between the controlled transaction and uncontrolled transactions. Therefore, most search processes will seek to eliminate transactions that have been entered into by entities that belong to a multinational group. However, where no more reliable comparables are available, group members with no or only very limited related party transactions which do not materially affect their gross or net margin may need to be used.

There can be advantages to restricting the search to publicly held companies since disclosure and audit requirements for such companies are typically more rigorous. Public companies are also generally required to provide considerably more detail in their audited financial statements and in the accompanying notes and management review of operations. However, in many cases, whether or not a potential comparable is publicly held is likely to be less important as a comparability factor than other considerations such as functional similarity. Thus, where data are scarce, eliminating potential comparables on this basis may not be pragmatic.

7 Type of financial accounts

This stage focusses on identifying entities that provide either consolidated or statutory financial accounts. Financial information of comparables should not be affected/influenced by connected circumstances. Care must be taken when using consolidated financial accounts. They may be used only if the functions conducted by the consolidated group equate to those of the tested party.

It is also important to ensure potential comparables' financial statements are audited, conform to generally accepted accounting principles (GAAP), have sufficient detail, and are available in a relatively consistent form over time.

8 Active/inactive entities

Inactive entities are usually screened out in the search process as circumstances between active and inactive entities are generally different.

9 Primary screening for functional comparability

This is an important step, which will often need to be continued in the secondary and tertiary screening phases of the process. In some cases, the key word search related to business activities described above can be refined by screening transactions based on certain amounts in the financial accounts which would indicate the existence (or absence) of certain functions or assets. For example, if the tested party does not undertake any research and development and does not use any intangibles which may have been created through R&D, it may be appropriate to include a screen to exclude entities which have non-negligible amounts of R&D expenses. See also the discussion of diagnostic ratios in [\[insert cross reference\]](#).

It may also be possible to screen out those entities engaged in significant business activities that are substantially dissimilar to the controlled transaction and are not adequately disclosed to allow segmentation should be excluded from the set of comparables.

Quantitative or Secondary screening, verification and selection

36. [B.2.3.4.34.] The quantitative screening step involves further screening the financial information relating to the potential comparables for the relevant period to determine whether their activities are comparable to that of the tested party, and they report sufficient data at the level needed to apply the selected transfer pricing method. Under this step, the search process focuses on a rigorous review of each transaction or company in the potential independent comparable pool against the full range of specific screening criteria. The objectives at this stage are verification, final screening and selection. This process is based on trial and error and requires multiple data sources, cross-checks and selected follow-up and confirmation of factual data. It will often be difficult to find 'perfect' comparables for a controlled transaction. Therefore, in undertaking the screening process, judgement is required. If the primary screening is applied too rigorously and inflexibly, it may be the case that no apparent comparables remain. In such cases it is particularly important to focus on the most economically significant characteristics of the controlled transaction while dispensing with other, less critical screening criteria for the transaction at hand (e.g. industry code or geographic location). Where this is the case, secondary screening can be particularly useful to refine the set of potential comparables.
37. [B.2.3.4.21.] For example, such screening may be done using diagnostic ratios. Diagnostic ratios are financial ratios applied to reject comparables that do not fulfil certain criteria.
38. [New] Particularly in cases where broad primary screening criteria have been used, diagnostic ratios can be used to improve the reliability of a potential set of comparables by helping to distinguish between results from transactions with differing degrees of comparability, and seeking to eliminate those with a lower degree of comparability from the potential comparable set. One or a combination of diagnostic ratios may be used as a kind of additional screen to narrow a range in cases where comparability defects remain in the potential comparables set that are otherwise difficult to eliminate, resulting in range that would otherwise be overly wide.
39. [New] For example, a ratio of marketing and advertising expenses to sales could be an indicator of the intensity of the marketing and advertising function undertaken. This ratio could then be used to refine the arm's length range based on comparables with similar levels of marketing / advertising intensity in

cases where the tested party makes sales to independent customers. Note that it would generally not be reliable to use a diagnostic ratio which comprises elements that are themselves the subject of related party transactions.

40. [B.2.3.4.22.] The application of diagnostic ratios is based on the assumption that a diagnostic ratio reflects a value driver of a particular line of business and is a reflection of the comparable functional and risk profile. In practice, it also depends on data availability. Most countries with transfer pricing rules acknowledge that the application of a net margin method is less sensitive to product and functional similarity than a traditional transaction method. However, functional comparability is still required in practice so a proper functional analysis and a good understanding of the tested business are essential in determining what diagnostic ratios may be useful, and to help avoid “cherry picking” or subjective use. Diagnostic ratios enable some of the features of a potential comparable that are economically relevant for the comparable search process to be taken into account when performing the comparable search.
41. [B.2.3.4.23.] In order to identify potential comparables with a similar functional and risk profile a diagnostic ratio measuring for example the level of wage costs compared to an appropriate base (e.g. total operating costs or total turnover) can be used as a yardstick to measure the level of technical manpower employed by comparable companies engaged in software development. The identification of a diagnostic ratio will depend upon several factors such as geographical location; the nature of the business, product and services; the product and service market etc. Using diagnostic ratios may help to identify comparables which are in line with the functional and risk profile of the tested party.
42. [B.2.3.4.24.] The diagnostic ratio is applied by using cut-off criteria. With this method, financials of the tested party are used to calculate the diagnostic ratios and these ratios are then used to create minimum or maximum values to reject companies. Once a cut-off is determined, generally all the values above or below a particular range of the cut-off will be eliminated, depending upon the facts and circumstances of each case. Subsequently, based on the functional and risk profile of the tested party, all companies with a diagnostic ratio above and below the cut-off range will be excluded.

Box – examples of diagnostic ratios

Diagnostic ratios can be a useful additional tool for refining a comparables search. Depending on the facts and circumstances, many different ratios can be envisaged. In determining an appropriate ratio to apply, consideration should be given as to what are the most economically significant characteristics of the tested transaction, and how such characteristics might be reflected in the accounts. It should be noted, however, that the ratio should not use amounts that relate to controlled transactions. For example, if an entity makes sales to a related party, it would generally not be reliable to use a sales-based ratio in the screening process.

Some examples diagnostic ratios are set out below:

- days of inventory (average)
- days receivable (average)
- days payable (average)
- turnover per employee
- fixed assets over total assets
- inventory over sales
- operating assets to total assets
- fixed assets to total sales
- fixed assets to number of employees
- operating expenses to sales
- cost of sales to sales
- inventory to total assets
- research and development expenses to total costs
- advertising and promotion expenses to total costs

Qualitative or Tertiary screening and interpretation of the data

43. [New]The final stage in the comparables search involves manual consideration of each potential comparable (particularly in the case where the results concerned are the gross or net profits of potentially comparable companies, rather than individual pricing data). For instance, this may involve a review of websites and other publicly available information on the shortlist of potentially comparable companies to ensure they are as reliable as possible.

B.2.3.5 Adjustments to comparables

[as is, except add a cross reference to toolkit examples on geographic and functional adjustments]

B.2.3.5A Interpreting the data to determine the arm's length price or range

44. [New]A comparability analysis may result in an “arm's length range” of financial indicators (prices or margins), all of which are considered to be equally reliable. (Note that in some countries, the domestic law will specify how such a range is to be derived from the final results of the comparables, for instance by the use of particular statistical techniques.) Where the transfer price is within this range, it is normally accepted as arm's length.
45. [New] However, it may be difficult to determine whether the search process has indeed resulted in a range of results, all of which are equally reliable. Uncertainty may also arise in cases where the range of results from a comparables search is very wide. Where such concerns exist therefore, it can be

helpful to consider whether it is possible objectively to determine whether some potential comparables are more reliable than others. The (further) use of diagnostic ratios and qualitative screening can sometimes be helpful in this regard.

46. [New] The search for reliable comparables is at the heart of most transfer pricing analyses. In many cases, it may not be straightforward, but rather, require the application of judgement. Care should thus be taken to consider potential screening criteria as objectively as possible, and avoid ‘cherry-picking’ data. Similarly, absent factual changes, it would be expected that such criteria would be used consistently over time.

B.2.3.6 Comparability considerations in the selection of transfer pricing methods

[as is]

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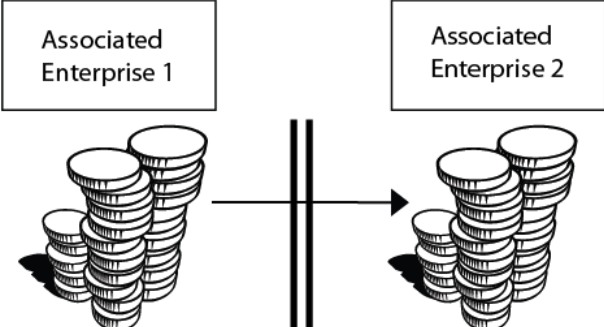
B.8.5. PRACTICAL GUIDANCE FOR CASES WITHOUT SUFFICIENT COMPARABLES

47. [B.8.5.1.] A critical issue for developing countries as well as developed countries when applying any methodology will often be the lack of third-party comparables, particularly comparables from the domestic market. As this Manual has shown, however, in many cases it may be the case that foreign comparables will be appropriate for the transfer pricing case at hand. Where this is not the case, for instance where it is found that the most appropriate method involves a local tested party and there are particularities in relation to the domestic market that mean foreign comparables are unlikely to be reliable, practical guidance in applying the arm's length principle and the transfer pricing rules without sufficient domestic information on independent comparables should be a key focus in domestic legislative frameworks. This Manual as a whole is intended to assist especially in this area; users should refer to Chapter B.2. on Comparability Analysis in particular. Domestic legislative frameworks and administrative guidelines should generally address the analysis of comparables as a benchmark of the arm's length principle. Such frameworks should seek to establish useful and effective guidance on matters such as comparability analysis (use of foreign data, adjustment of differences, profit split etc.), access to data, safe harbour rules, if any, and burden of proof. It is worth paying attention to the new [replace with cross reference to Sixth method in the Manual]⁷⁵ See the chapter on Methods (Chapter B.3. of this Manual) for more details.
48. [New] In addition, the Toolkit Addressing a Lack of Access to Comparables for Transfer Pricing Analyses contains a number of useful suggestions that could be considered in cases where there is a systemic problem involving a lack of comparables. For example, the toolkit:
- Suggests ways in which government agencies can increase the pool of available comparables data, for example, by instituting requirements to publish audited financial statements
 - Recommends focusing on risk assessment approaches that consider the arm's length nature of related party transactions, so as to ensure scarce audit resources are concentrated on cases most likely to yield results
 - Suggests consideration of safe harbours, fixed margins or other prescriptive approaches [insert cross reference to sections below on presumptive approaches B.8.7 and safe harbours B.8.8]
 - Discusses the application of the profit split method and the use of valuation techniques which do not directly rely on comparables data, where it is found that such approaches constitute the most appropriate means of determining arm's length prices or profits
 - Suggests consideration of cooperative compliance approaches in appropriate cases as a means of helping tax administrations to access industry information which may otherwise be difficult to obtain. Suggests the use of anti-avoidance measures as a backstop to the transfer pricing rules in the most egregious cases, or those where there is a high risk of systemic abuse.
49. [B.8.5.2.] Ease of administration is another important issue in the design of legal frameworks. Documentation requirements supported by penalties for non-compliance are the main instruments used by tax authorities for collection of sufficient information to test whether or not taxpayers have established an arm's length result. Preparing documentation is one of the most expensive compliance costs for MNEs, especially if there are differences in countries' requirements. There is value in seeking to align documentation requirements with those of other countries, especially in the same region, unless there are good reasons in terms of reducing compliance and collection costs, or specific features of local legislation, that require differences. The OECD/G20 BEPS Project specifically focused on transfer pricing documentation and country-by-country reporting. In October 2015 a report providing guidance on the implementation of these measures under action 13 was published.⁷⁶

50. [B.8.5.3] Some differences in the coverage of transactions or in the legal form (statutes with penalty provisions or administrative guidance on self-assessment) will remain. It is therefore appropriate to continuously evaluate documentation and penalty legislation for efficiency and proportionality. The experience of countries that have introduced transfer pricing rules may be relevant to developing countries just starting to develop capability in transfer pricing. For example, at the initial stage of transfer pricing administration in the early 1990s, Japanese transfer pricing examiners experienced difficulties in collecting information about affiliated enterprises that was physically held overseas. Documentation requirements were very basic under Japanese domestic legislation at that time; examiners had to exercise their ordinary domestic investigation powers to inquire from taxpayers about international related party transactions. They soon identified that not all relevant information was necessarily kept by the Japanese unit. Japan therefore started a process of adjusting documentation requirements to reflect the actual international business practice of multinational groups by ensuring effective compliance but also taking into consideration the taxpayers' compliance burden. See Chapter C.2. on Documentation for specific country practices.

**ATTACHMENT C: PROPOSED REVISED TEXT FOR CHAPTER B.3.3 -
PROFIT SPLITS**

[B.3.3.13.] Profit Split Method (introduction)

Existing text of the TP Practical Manual	Proposed revision
<p>B.3.3.13.1. The Profit Split Method is typically applied when both sides of the controlled transaction contribute significant intangible property. The profit is to be divided such as is expected in a joint venture relationship.</p>	<p>1. The profit split method is a useful, but often complex method of determining transfer prices based on an allocation of the relevant, combined profits made by the related parties in relation to the transaction(s).</p>
<p>B.3.3.13.2. The Profit Split Method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that it is appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions. Figure B.3.5 illustrates this.</p>	<p>2. The Profit Split Method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that it is appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions.</p>
<p>Figure B.3.5: Profit Split Method</p>  <p>The diagram shows two boxes labeled 'Associated Enterprise 1' and 'Associated Enterprise 2'. Below each box is a stack of coins. A vertical double line separates the two stacks. An arrow points from the stack of coins under Enterprise 1 to the stack of coins under Enterprise 2, indicating a transfer or division of profits.</p>	<p>[Delete figure B.3.5]</p>
<p>B.3.3.13.3. The Profit Split Method starts by identifying the profits to be divided between the associated enterprises from the controlled transactions. Subsequently, these profits are divided between the associated enterprises based on the relative value of each enterprise's contribution, which should reflect the functions performed, risks incurred and assets used by each enterprise in the controlled transactions. External market data (e.g. profit split percentages among independent enterprises performing comparable functions) should be used to value each enterprise's contribution, if possible, so that the division of combined profits between the associated enterprises is in accordance with that between independent enterprises performing functions</p>	<p>3. The profit split method may be appropriate where:</p> <ul style="list-style-type: none"> • each related party to the transaction makes unique and valuable contributions; and/or • the business operations of the related parties are so highly integrated that they cannot be reliably evaluated in isolation from each other; and/or • the parties share the assumption of economically significantly risk or separately assume closely related risks. <p>See paragraph 8 et seq.</p>

ATTACHMENT C : PROFIT SPLITS

comparable to the functions performed by the associated enterprises. The Profit Split Method is applicable to transfer pricing issues involving tangible property, intangible property, trading activities or financial services.

4. The profit split method starts by identifying the relevant profits, or indeed losses in relation to the controlled transactions. It then seeks to split those profits or losses between the associated enterprises involved on an economically valid basis in order to achieve an arm's length outcome for each party. Typically, the split should reflect the relative value of each enterprise's contribution, including its functions performed, risks assumed and assets used or contributed.
5. The profit split method is also referred to as the transactional profit split method. It can be distinguished from global formulary apportionment approaches as follows. The profit split method typically does not start with the global or total combined profits of the entire MNE group. Rather, it begins from the relevant profits in relation to particular transactions between two or more associated enterprises. Moreover, in order to comply with the arm's length principle, the way in which the method is applied should not be arbitrary, but rather should approximate the results achieved had the parties been independent of each other. In particular, the factors by which the relevant profits are split between the associated enterprises to the transaction is typically based on measures of their relative contributions to value creation rather than an arbitrary formula.

[MOVED BELOW]

[B.3.3.16.] Strengths and Weaknesses

<p>B.3.3.16.1. The strengths of the Profit Split Method include:</p> <ul style="list-style-type: none"> ➤ It is suitable for highly integrated operations for which a one-sided method may not be appropriate; ➤ It is suitable in cases where the traditional methods prove inappropriate due to a lack of comparable transactions; ➤ The method avoids an extreme result for one of the associated enterprises involved due to its two-sided approach (i.e. all parties to the controlled transaction are being analysed); and ➤ This method is able (uniquely among commonly used transfer pricing methods) to deal with returns to synergies between intangible assets or profits arising from economies of scale. 	<p>6. The strengths of the profit split method include:</p> <ul style="list-style-type: none"> • It can provide a solution in cases where one-sided methods are not appropriate because each party to the transaction makes a unique and valuable contribution which cannot be benchmarked; • It can be used where the level of integration, or the sharing of risks between the related parties means that the contribution of each party cannot be evaluated in isolation from those of other parties; • As a two-sided method, all relevant parties to the transaction are directly evaluated, helping to ensure an arm's length result for each entity based on the relative value of its specific contributions, even in cases where there may be specific or unique facts and circumstances which may not be present in transactions between independent enterprises; • It is able to deal with returns to synergies between contributions or profits arising from economies of scale.
<p>B.3.3.16.2. The weaknesses of the Profit Split Method include:</p> <ul style="list-style-type: none"> ➤ The relative theoretical weakness of the second step. In particular, the theoretical basis for the assumption that synergy value is divided pro rata to the relative value of inputs is unclear (although this approach is arguably consistent with the way interests are divided between participants in a joint venture); ➤ Its dependence on access to data from foreign affiliates. Associated enterprises and tax administrations may have difficulty 	<p>7. The weaknesses of the profit split method include:</p> <ul style="list-style-type: none"> • The profit split method is often complex to apply. It may be difficult to measure the relevant revenues and costs to be split between the related parties. In addition to measurement difficulties, the method is typically highly reliant on detailed data from the MNE group. (See also sections B.1.6 and C.2 of this Manual, which deal with transfer pricing documentation.) Determining an appropriate way to

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<p>obtaining information from foreign affiliates; and</p> <p>➤ Certain measurement problems exist in applying the Profit Split Method. It may be difficult to calculate combined revenue and costs for all the associated enterprises taking part in the controlled transactions due to, for example, differences in accounting practices. It may also be hard to allocate costs and operating expenses between the controlled transactions and other activities of the associated enterprises.</p>	<p>split the profits can also be challenging. Care must be taken to ensure the application of the profit split method is as objective as possible. Since reliable, direct information on the allocation of profits in comparable independent transactions is relatively rare, the profit split method often relies on less direct information or proxies (e.g. relative value of the contributions of each party) in its application of the arm's length principle.</p>
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[B.3.3.17.] When to Use the Profit Split Method

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8. As with any transfer pricing method, the profit split should be used where it is found to be the most appropriate method to the circumstances of the case. Primarily, this determination is based on the nature of the accurately delineated transaction in the context of its circumstances. The analysis to determine the accurately delineated transaction should consider the commercial and financial relations between the related parties, a consideration of their functions performed, assets used or contributed, and risks assumed, and how the activities of the parties impact the transaction given the market context in which the transaction occurs.
9. While as noted above, the profit split method can be a complex method to apply reliably, the determination of when it is the most appropriate method should be done as objectively as possible. That is, the profit split method should not simply be regarded as a method of last resort. Moreover, while the method may require relatively more, or more detailed information from the taxpayer and its associated enterprise(s) than other methods, where it is indeed found to be the most appropriate method, reasonable efforts should be made to gather such necessary information which, after all, will typically be in the hands of the MNE group.
10. While it is not possible to be prescriptive, as noted above, indicators that a profit split may be the most appropriate method include:
 - Where each related party to the controlled transaction makes a unique and valuable contribution; and/or
 - Where the business operations of the related parties are so highly integrated that the contributions of the parties cannot be reliably evaluated in isolation from each other; and/or
 - Where the related parties either share the assumption of the key economically significant risks associated with the transaction(s), or separately assume closely related economically significant risks associated with the transactions.
11. The presence of any one or more of these indicators suggests that the profit split may be the most appropriate method.

12. Where one or more of the above indicators is present, it is highly unlikely that reliable comparable transactions will be available. However, a lack of comparables per se is insufficient evidence to conclude that a profit split will be the most appropriate method. That is, the profit split method should not become a convenient method to be applied in every case where close comparables cannot be identified.
13. In contrast, where none of the indicators are present and the accurate delineation of the transaction shows that one of the related parties to the transaction performs functions, uses or contributes assets and assumes risks that can be reliably benchmarked by reference to uncontrolled comparables, a profit split is unlikely to be the most appropriate method. In such cases, it is likely to be more reliable to apply a transfer pricing method making use of the uncontrolled comparables, even in cases where ‘perfect’ or closely comparable uncontrolled transactions are lacking. See *[insert cross reference to lack of comparables.]* As with any other method, pricing practices used between independent parties engaged in similar transactions in the same industry or market can provide information relevant to the analysis of the most appropriate transfer pricing method.
14. It is sometimes argued that since the profit split method is seldom used among independent enterprises, its application in controlled transactions should be similarly rare. Whether or not the premise of this argument is correct, where the method is found to be the most appropriate to the circumstances, this should not be a factor. Transfer pricing methods, including the profit split method, are not necessarily intended to replicate the way in which independent parties establish prices among themselves; rather, they are a way in which the arm’s length principle can be applied in order to determine appropriate transfer prices in controlled transactions. That said, if there is evidence (e.g. from a joint venture or similar arrangement) that independent parties in comparable circumstances use a profit split method among themselves, this may suggest that a profit split will also be the most appropriate method in relation to the controlled transactions.

Unique and valuable contributions by each party

15. Perhaps the clearest indicator that the profit split method may be the most appropriate method involves situations in which each party to the controlled transaction makes unique and valuable contributions. Such contributions (e.g. functions performed, assets used or contributed, including intangibles) will be “unique and valuable” where:

- (i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances; and
- (ii) they represent a key source of actual or potential economic benefits in the business operations.

Together, these factors mean that the application of other transfer pricing methods may not be capable of reliably determining an arm’s length outcome because neither related party can be reliably benchmarked by reference to comparables.

16. When evaluating whether certain contributions are unique and valuable such that a profit split method may be the most appropriate, a consideration of the context of the transaction, including the industry and market in which it occurs and the factors which affect business performance in that context are particularly relevant. *[Insert cross references to chapter on unique and valuable intangibles – relationship with assumption of economically significant risks relating to development, obsolescence, infringement, product liability and exploitation.] [Add cross reference to on Transfers of fully developed intangibles (including rights in intangibles) where there are no CUP/CUTs and transfers of partially developed intangibles]*

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Example 1 [Company A and Company B each contribute a unique and valuable intangible]

Company A, a resident of country A has developed, by its own efforts, a trademark and associated brand for an over the counter seasonal hayfever medicine, “Seritum”. The Seritum trademark and brand are well known throughout the A-B region. The trademark and reputation of the brand allows Company A to charge a premium for Seritum hayfever medicine over the chemically equivalent generic product.

Company B, an associated enterprise of Company A resident in country B, has developed, by its own efforts, a version of the generic hayfever medicine that is also effective for other allergies, such as those triggered by cats and dogs. This modification is sufficiently different and innovative that B has been granted a patent for its modified compound. Clinical trials conducted on the modified compound show it to be safe and effective, and to provide symptomatic relief for people allergic to cats and dogs, as well as seasonal hayfever.

Company A enters into an agreement with Company B to market the modified allergy medicine under the trademark “AllSeritum” in the A-B region. A marketing strategy is devised and a campaign undertaken by Company A to market the new product in region A-B based on the familiarity of the “Seritum” brand as well as the expanded application and efficacy of the new product.

AllSeritum turns out to be highly successful. It can access a previously untapped market for allergy medicines; the pharmacological compound has the benefit of patent protection for the following 10 years; and customers were already familiar with, and trusted the Seritum brand.

In this case the most appropriate method is determined to be a profit split method since both A and B make unique and valuable contributions: the unique and valuable trademark and associated brand in the case of A, and the unique and valuable patent in the case of B.

Example 2 [Unique and valuable DAEMPE functions]

Dades Enterprises, a resident of country G is in the business of software development and provides tailored software solutions to customers. Dades Enterprises has developed certain proprietary software relating to 3D mapping of underground aquifers. Subsequently, Dades Limited, a resident of country I and a member of the same MNE group as Dades Enterprises, enters into an agreement with Client M, an independent party, for the supply of similar software, tailored to the mapping of underground liquid hydrocarbons. Dades Enterprises provides Dades Limited with access to the relevant code, software designs and know-how developed in the original project. The legal agreement between the entities states that Dades Enterprises will retain legal ownership in any and all resulting software based on the original product.

Dades Limited engages its own engineers to further develop and enhance the original software. The resulting product is largely based on the original proprietary software developed by Dades Enterprises, but contains material enhancements.

The transfer pricing analysis shows that both Dades Enterprises and Dades Limited made unique and valuable contributions to the development of the enhanced software developed for Client M. Dades Enterprises’s contribution was in the form of the unique and valuable proprietary software, and Dades Limited in the form of unique and valuable contributions to the development and enhancement of that software. As a result of this, the profit split is determined to be the most appropriate method in this case.

Example 2A [Material but not unique and valuable DAEMPE functions]

The facts are the same as in Example 2, except that the development and enhancement activity conducted by Dades Limited is less significant and relates only to enhancing the original proprietary software so that it accepts a wider range of data input formats. In this case, the contribution of Dades Limited is found not to be unique and valuable, and as a result, a one-sided method is likely to be the most appropriate way of determining an arm’s length price for the transaction.

Highly integrated operations

<p>B.3.3.17.1. The Profit Split Method might be used in cases involving highly interrelated transactions that cannot be analysed on a separate basis. This means that the Profit Split Method can be applied in cases where the associated enterprises engage in several transactions that are so interdependent that they cannot be evaluated on a separate basis using a traditional transaction method. In other words, the transactions are so interrelated that it is impossible to identify comparable transactions. In this respect, the Profit Split Method is applicable in complex industries such as, for example, the global financial services business.</p>	<p>17. All MNE groups have business operations which are integrated to some degree. However the profit split method is likely to be the most appropriate method only in those cases where the integration is so significant that the way in which each party performs functions, uses assets, and assumes risks is interlinked with and cannot be reliably evaluated in isolation from the way in which another related party to the transaction performs functions, uses assets and assumes risks.</p> <p>18. One example of highly integrated operations which may warrant the determination that the profit split is the most appropriate method could be where the related parties perform functions jointly, use common assets jointly and/or share the assumption of economically significant risks, and do so to such an extent that their respective contributions cannot be evaluated in isolation.</p> <p>19. Another example may be where the integration between the related parties takes the form of a high degree of inter-dependency. For instance, a profit split may be found to be the most appropriate method where, under a long-term arrangement, each party has made a significant contribution (e.g. of an asset) whose value depends in large degree on the other party. In such cases, a profit split approach could allow for pricing which appropriately takes into account and varies with the outcome of the risks assumed by each party.</p>
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Example 3 [Significant integration]

Stefanelli Enterprises Inc (SEI), incorporated in country M and Stefanelli Enterprises Corporation (SEC), a resident of country N are members of an MNE group specialising in providing trade facilitation for agricultural commodities and bulk chemicals. The prices for the products themselves are largely determined based on exchange-quoted prices. Stefanelli's customers may be either suppliers or purchasers of the products and tend to operate in both country M and country N. Customers expect the same standard of service in both countries and rely on the integrated nature of Stefanelli's operations in each country to provide a seamless service in moving products from and to the two countries. Customers contract with either SEI or SEC depending on the country in which the trade originates. Functions associated with marketing and customer relations are undertaken by SEI or SEC, depending on the location of the customer. A functional analysis shows that SEI and SEC perform similar activities in fulfilling customer contracts, including arranging transportation and warehousing where required, as well as facilitating customs clearance in the exporting and importing countries, irrespective of which enterprise holds the contract with the customer. Therefore, both SEI and SEC support each other and provide services to one another in fulfilling their respective contracts. SEI or SEC may also source supplies for buyers or seek out customers on behalf of suppliers, but they do not take positions on the purchase and sale of the products on their own account. Instead, they either act as an agent, or enter into simultaneous purchase and sale agreements.

SEI and SEC perform a similar range of functions and must cooperate extremely closely in order to effectively and efficiently provide services to the group's customers. The two entities jointly use and contribute to the further development of the group's economically significant assets, being its know how, customer and supplier relationships, and its IT systems. The group markets itself to customers based on its efficiency and ability to provide seamless, integrated services in both countries M and N.

Although market data exists about fees charged for trade facilitation services, it is found that the level of integration between SEI and SEC is so significant that their operations cannot be reliably evaluated in isolation from each other. As a result, the profit split is determined to be the most appropriate method in this case.

Example 4 [Complementary but discrete activities – not sufficiently highly integrated to warrant profit split]

Schol Manufacturing, a resident of country A, is a fully fledged manufacturer of plastic products for the food service industry. Schol Distribution, an associated enterprise of Schol Manufacturing located in country B, imports these products and distributes them in the local market to food processing companies, restaurants, caterers, retail food outlets etc. Schol Distribution only purchases products from Schol Manufacturing and is wholly dependent on the latter for its supply of products. Schol Distribution provides customer feedback to Schol Manufacturing, but does not otherwise participate in the design or production process. A functional analysis shows that Schol Distribution does not make any unique and valuable contributions. For instance, it has not developed a highly valuable trademark or tradename for the plastic products in the market.

Schol Manufacturing is also highly dependent upon Schol Distribution since it does not have any sales or distribution functions in country A. Without Schol Distributions, it would find it very difficult to sell its products into the country A market.

While Schol Manufacturing and Schol Distribution are highly dependent upon each other, an appropriate arm's length remuneration for each of them can be determined without the need to consider their activities

together. For example, the distribution activities of Schol Distribution might be able to be reliably benchmarked through the application transactional net margin method and looking to comparable uncontrolled distributors. In this case therefore, the profit split is unlikely to be the most appropriate method.

Shared risks

20. A further indicator that the profit split may be the most appropriate method is where the parties to controlled transaction share the assumption of the economically significant risks in relation to the transaction *[insert cross reference to section on risk]*. It may also be the most appropriate method in cases where the parties separately assume risks that are so closely related or inter-linked that the playing out of the risks of each party cannot be reliably isolated from the risks assumed by the counterparties.
21. The relevance of risk-sharing to the determination of the most appropriate transfer pricing method will depend greatly on the extent to which the risks concerned are economically significant such that each party should be entitled to a share of the relevant profits associated with the controlled transaction(s) had the transaction occurred at arm's length.

Example 5 [Shared assumption of risks]

Global trading of financial instruments under an integrated trading model where each enterprise or location within the group performs the full range of trading and risk management functions, that is the enterprise jointly performs the same key functions, use the same key assets and assume the same economically significant risks. Moreover, each enterprise or location cannot act independently and instead must co-operate with others in order to successfully enter into transactions and manage and control the risks related to those transactions.

Bank B operates as a global trader of financial instruments. The headquarters of the bank has a number of subsidiaries and branches around the world which underwrite and distribute financial products, act as a market-maker in securities and derivative instruments, and perform brokerage functions for clients trading on stock and commodities exchanges around the world. As a result of these activities, Bank B mainly earns income in the form of interest and dividends from the inventories it holds to be a market-maker on physical securities, (net) gains on the trading of financial instruments, income from derivatives and fees from clients.

Bank B operates its global trading business using integrated trading model. That is, traders in each of its main trading centres in countries X, Y and Z (each of which is in a time zone which is at least five hours different from the other) set prices and trade off a portfolio of positions (the "book") while the market is open in that country. When the markets in a particular country close, responsibility for trading the book is passed on to main trading centre in the next time zone. Traders in each main trading centre have full control over the book and may close positions passed to them and open new ones. However, the legal ownership of the book does not change with the handover in control. The overall parameters and limits for allowable trades are set by a committee which comprises roughly equal numbers from each of the main trading centres, however, in each location, traders enter into transactions with customers based on their own professional decision making. The functional analysis shows that the main trading centres in countries X, Y and Z use the assets of the business jointly, and they jointly assume the economically significant risks. Each trading location undertakes broadly the same functions or activities and must cooperate with the others in order to successfully undertake their business and manage and control the risks associated with those transactions.

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Significant additional efficiencies and profit opportunities arise from the ability of Bank B to trade its book on a 24-hour basis. Traders in each location receive a base salary together with performance pay based on a share of a bonus pool determined according to the overall profitability of the book.

In this example, the main trading centres, through their close co-operation and joint performance of activities, share the assumption of the economically significant risks. As a result, the profit split method is found to be the most appropriate method.

Availability of information

22. It will often be the case that where the profit split is found to be the most appropriate method, direct comparable transactions that may otherwise be used to price the transaction will not be found. However, information from uncontrolled transactions may still be relevant to the application of the profit split method, for example in terms of the how the relevant profits should be split amongst the parties, or in the first part of a residual profit split [See paragraph 46 et seq and paragraph 31, respectively; see also paragraph 13 on the relevance of market information.]

[B.3.3.14.] How to apply the profit split method

23. As was noted at the beginning of this section, in general, a profit split method first determines the relevant profits, being the total profits in relation to the controlled transactions under examination, and then splits those profits on an economically valid basis. There are a number of different approaches as to how those relevant profits are allocated between the associated enterprises, including the contribution and residual analysis approaches. These are discussed in more detail below.

24. As with all transfer pricing methods, care should be taken to avoid the use of hindsight in the application of the profit split method (see paragraph 46). In general, where it is found to be the most appropriate method, the profit split method should be applied consistently to transactions over time, irrespective of the amount of the relevant profits (or indeed if there are losses). Applications of the method which vary depending on the amount of the relevant profits may be found to be arm's length in some cases, but would be less common. If there are significant unforeseen developments which would have resulted in a renegotiation of the agreement between the parties had they been at arm's length, a different application (going forward) may be warranted. For example, a different way of determining the relevant profits or how to split them might be agreed. In such cases, documenting the reasons for the different application would be essential.

[The paragraph above has now been agreed by the Subcommittee.]

25. When applying or evaluating the use of the profit split method it is important to ensure that the complexity of the process does not result in losing sight of the intended result: an arm's length outcome for each related party involved. In some cases therefore, particularly where the process relies on multiple assumptions or complex calculations, it may be useful to perform a 'reality check' of the outcomes using alternative methods or means.

B.3.3.14.1. There are generally considered to be two specific methods to allocate the profits between the associated enterprises: contribution analysis and residual analysis.

26. There are several ways in which the profit split method can be applied.

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	<i>Contribution Analysis</i>
<p>B.3.3.14.2. Under the contribution analysis the combined profits from the controlled transactions are allocated between the associated enterprises on the basis of the relative value of functions performed by those associated enterprises engaged in the controlled transactions. External market data that reflect how independent enterprises allocate the profits in similar circumstances should complement the analysis to the extent possible.</p>	<p>27. Under a contribution analysis, the relevant profits are allocated between the associated enterprises engaged in the controlled transactions in a way that aims to reflect a reasonable approximation of the divisions that would have been agreed by independent enterprises in similar circumstances. Relevant external market data, i.e. from comparable independent transactions between unrelated enterprises or between the taxpayer and an unrelated enterprise, should be used to support this allocation where available. However more commonly, such external data will not be obtainable. In such cases, the arm's length principle can be applied by using data internal to the taxpayers themselves to determine the relative value of the contributions of each party to the controlled transaction(s). For example, this might be done by comparing the nature and degree of each party's contributions to the controlled transactions and assigning a percentage based on that relative comparison (and any external market data that may be available).</p>
<p>B.3.3.14.3. If the relative value of the contributions can be calculated directly, then determining the actual value of the contribution of each enterprise may not be required. The combined profits from the controlled transactions should normally be determined on the basis of operating profits. However, in some cases it might be proper to divide gross profits first and subsequently subtract the expenses attributable to each enterprise.</p>	<p>28. The way in which the value of such contributions is measured will depend on the facts of each case. The determination of appropriate profit splitting factors is discussed in more detail below [See paragraph 46 et seq]. Note that if the relative value of the contributions can be determined, then calculating the actual value of the contribution of each enterprise may not be required.</p>
	<i>Residual analysis</i>
<p>B.3.3.14.4. Under the residual analysis the combined profits from the controlled transactions are allocated between the associated enterprises based on a two-step approach:</p>	<p>29. While a contribution analysis takes the relevant profits in relation to the transaction and splits them between the parties in a single step, the profit split method can be applied using a staged approach under a residual analysis. Such an approach is likely to be appropriate where one or more parties to the controlled</p>

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	<p>transaction(s) makes a contribution(s) which is routine and could be benchmarked based on comparables.</p>
<p>➤ <i>Step 1:</i> allocation of sufficient profit to each enterprise to provide basic arm's length compensation for routine contributions. This basic compensation does not include a return for possible valuable intangible assets owned by the associated enterprises. The basic compensation is determined based on the returns earned by comparable independent enterprises for comparable transactions or, more frequently, functions. In practice TNMM is used to determine the appropriate return in Step 1 of the residual analysis; and</p>	<p>30. <i>Step 1:</i> allocation of an arm's length profit to each enterprise to compensate it for its routine or benchmarkable contributions. Typically this is done by the application of one-sided transfer pricing methods such as the TNMM and consideration of the returns earned by independent enterprises engaged in activities which are comparable to those routine or benchmarkable contributions. In this first step, other contributions, such as those which are unique and valuable, are not taken into account. Each related party is allocated an appropriate 'routine' return from the pool of relevant profits.</p>
<p>➤ <i>Step 2:</i> allocation of residual profit (i.e. profit remaining after Step 1) between the associated enterprises based on the facts and circumstances. If the residual profit is attributable to intangible property then the allocation of this profit should be based on the relative value of each enterprise's contributions of intangible property.</p>	<p>31. <i>Step 2:</i> allocation of residual profit (i.e. remaining relevant profits after the Step 1 allocation) on an economically valid basis. In the second step, other contributions not already accounted for, including those which are unique and valuable, are considered. As was described above in relation to a contribution analysis, this allocation must be done on an economically valid basis, and aim to achieve a reasonable approximation of the divisions that would have been agreed by independent enterprises in similar circumstances. The second step allocation will thus typically consider the relative value of the contributions of each party to the residual profits, supplemented where possible by external market information on how independent parties would have divided such profits in similar circumstances.</p>
<p>B.3.3.14.5. The residual analysis is typically applied to cases where both sides of the controlled transaction contribute valuable intangible property to the transaction. For example, Company X manufactures components using valuable intangible property and sells these components to a related Company Y which uses the components and also uses valuable intangible property to manufacture final products and sells them to customers. The first step of a residual analysis would allocate a basic (arm's length) return to Company X for its</p>	<p>32. As has been noted above, since reliable, direct information on how profits would have been allocated in comparable uncontrolled transactions might not be available, care is required in applying the profit split method. The residual approach to the application of the method aims to reduce possible subjectivity by confining, to the extent possible, the more difficult step 2 allocation (which is typically not based directly on comparables data).</p>

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<p>manufacturing function and a basic (arm’s length) return to Company Y for its manufacturing and distribution functions. The residual profit remaining after this step is attributable to the intangible properties owned by the two companies. The allocation of the residual profit is based on the relative value of each company’s contributions of intangible property. The OECD Guidelines do not refer to specific allocation keys to be used in this respect. Step 2 may not, and typically does not, depend on the use of comparables.</p>	<p><i>Example 6</i></p> <p>[added from B.3.3.14.5] Company X manufactures components using unique and valuable intangibles and sells these components to a related party, Company Y. Company Y then uses the components, together with its own unique and valuable intangibles, to manufacture final products, which it sells to independent customers. The first step of the residual analysis would allocate a basic, ‘routine’ or benchmarkable arm’s length return to Company X for its manufacturing function, and a basic, ‘routine’ or benchmarkable arm’s length return to Company Y for its manufacturing and distribution functions. The relevant profits from the transactions, less the amounts of the basic or ‘routine’ returns to Company X and Company Y, will be the residual profit. This residual profit is then split between the parties based on the relative value of their respective unique and valuable contributions. This second step of splitting the residual profits need not, and typically does not, depend on the use of comparables.</p>
<p>B.3.3.14.6. The following approaches have been specified in some jurisdictions to determine the relative value of each company’s contributions of intangible property:</p> <ul style="list-style-type: none"> ➤ External market benchmarks reflecting the fair market value of the intangible property; ➤ The capitalized cost of developing the intangibles and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible; and ➤ The amount of actual intangible development expenditures in recent years if these expenditures have been constant over time and the useful life of the intangible property of all parties involved is broadly similar. 	<p>33. The following approaches have been specified in some jurisdictions to determine the relative value of each company’s contributions of intangibles:</p> <ul style="list-style-type: none"> • External market benchmarks reflecting the fair market value of the intangible property; • The capitalized cost of developing the intangibles and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible;¹ and • The amount of actual intangible development expenditures in recent years if these expenditures have been constant over time and the useful life of the intangible property of all parties involved is broadly similar.
<p>B.3.3.14.7. The Residual Profit Split Method is used more in practice than the contribution</p>	<p>34. The residual approach is used more in practice than the contribution approach for two reasons.</p>

¹A disadvantage of this approach is that cost may not reflect the market value of the intangible property.

<p>approach for two reasons. Firstly, the residual approach breaks up a complicated transfer pricing problem into two manageable steps. The first step determines a basic return for routine functions based on comparables. The second step analyses returns to (often unique) intangible assets based not on comparables but on relative value which is, in many cases, a practical solution. Secondly, potential conflict with the tax authorities is reduced by using the two-step residual approach since it reduces the amount of profit that is to be split in the potentially more controversial second step.</p>	<p>Firstly, the residual approach breaks up a complicated transfer pricing problem into two manageable steps. The first step determines a basic return for routine or benchmarkable functions based on comparables and the application of a one-sided method or methods. The second step analyses returns to unique and valuable contributions or other elements which are un-benchmarkable. Rather than trying to determine absolute values for these contributions based on comparables, the method focuses on their relative value which may often be determined more reliably. Secondly, potential conflict with the tax authorities is reduced by using the two-step residual approach since it reduces the amount of profit that is to be split in the potentially more controversial second step.</p>
<p>B.3.3.18. Examples: Application of Residual Profit Split</p> <p>(i) XYZ is a corporation that develops, manufactures and markets a line of products for use by the police in Country A. XYZ's research unit developed a bulletproof material for use in protective clothing and headgear (Stelon). XYZ obtains patent protection for the chemical formula for Stelon. Since its introduction, Stelon has captured a substantial share of the market for bulletproof material.</p> <p>(ii) XYZ licensed its Asian subsidiary, XYZ-Asia, to manufacture and market Stelon in Asia. XYZ-Asia is a well-established company that manufactures and markets XYZ products in Asia. XYZ-Asia has a research unit that adapts XYZ products for the defence market, as well as a well-developed marketing network that employs brand names that it has developed.</p> <p>(iii) XYZ-Asia's research unit alters Stelon to adapt it to military specifications and develops a high-intensity marketing campaign directed at the defence industry in several Asian countries. Beginning with the 2009 taxable year, XYZ-Asia manufactures and sells Stelon in Asia through its marketing network under one of its brand names.</p>	<p><i>Example 7 – Application of residual profit split²</i></p> <p>(i) XYZ is a corporation that develops, manufactures and markets a line of products for use by the police in Country A. XYZ's research unit developed a bulletproof material for use in protective clothing and headgear (Stelon). XYZ obtains patent protection for the chemical formula for Stelon. Since its introduction, Stelon has captured a substantial share of the market for bulletproof material.</p> <p>(ii) XYZ licensed its Asian subsidiary, XYZ-Asia, to manufacture and market Stelon in Asia. XYZ-Asia is a well-established company that manufactures and markets XYZ products in Asia. XYZ-Asia has a research unit that adapts XYZ products for the defence market, as well as a well-developed marketing network that employs brand names that it has developed.</p> <p>(iii) XYZ-Asia's research unit alters Stelon to adapt it to military specifications and develops a high-intensity marketing campaign directed at the defence industry in several Asian countries. Beginning with the Y1 taxable year, XYZ-Asia manufactures and sells Stelon in Asia through its marketing network under one of its brand names.</p>

² This example is intended simply to illustrate the mechanics of the application of a residual approach under the profit split method. No inference should be drawn from this example as to the appropriateness of the profit splitting factors (or other parameters) to any superficially similar cases. In particular, the relative capitalised, amortised expenses of the intangibles may not always reflect the relative contributions to value made by the parties; where this is the case, an alternative means of evaluating those contributions will be required.

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<p>(iv) For the 2009 tax year XYZ has no direct expenses associated with the license of Stelon to XYZ-Asia and incurs no expenses related to the marketing of Stelon in Asia. For the 2009 tax year XYZ-Asia's Stelon sales and pre-royalty expenses are \$500 million and \$300 million, respectively, resulting in net pre-royalty profit of \$200 million related to the Stelon business. The operating assets employed in XYZ-Asia's Stelon business are \$200 million. Given the facts and circumstances, Country A's taxing authority determines that a residual profit split will provide the most reliable measure of an arm's length result. Based on an examination of a sample of Asian companies performing functions similar to those of XYZ-Asia the district director determines that an average market return on XYZ-Asia's operating assets in the Stelon business is 10 per cent, resulting in a market return of \$20 million (10% x \$200 million) for XYZ-Asia's Stelon business, and a residual profit of \$180 million.</p> <p>(v) Since the first stage of the residual profit split allocated profits to XYZ-Asia's contributions other than those attributable to highly valuable intangible property, it is assumed that the residual profit of \$180 million is attributable to the valuable intangibles related to Stelon, i.e. the Asian brand name for Stelon and the Stelon formula (including XYZ-Asia's modifications). To estimate the relative values of these intangibles the taxing authority compares the ratios of the capitalized value of expenditures as of 2009 on Stelon-related research and development and marketing over the 2009 sales related to such expenditures.</p> <p>(vi) As XYZ's protective product research and development expenses support the worldwide protective product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide business activities to which they relate. The taxing authority determines that it is reasonable to allocate the value of these expenses based on worldwide protective product sales. Using information on the average useful life of its investments in protective product research and development, the taxing authority capitalizes and amortizes XYZ's protective product research and development expenses. This analysis indicates that the capitalized research and development expenditures have a value of \$0.20 per dollar of global protective product sales in the 2009 tax year.</p> <p>(vii) XYZ-Asia's expenditures on Stelon research and</p>	<p>(iv) For the Y1 tax year XYZ has no direct expenses associated with the license of Stelon to XYZ-Asia and incurs no expenses related to the marketing of Stelon in Asia. For the Y1 tax year XYZ-Asia's Stelon sales and pre-royalty expenses are \$500 million and \$300 million, respectively, resulting in net pre-royalty profit of \$200 million related to the Stelon business. The operating assets employed in XYZ-Asia's Stelon business are \$200 million. Given the facts and circumstances, it is determined that a residual profit split is the most appropriate method and will provide the most reliable measure of an arm's length result. Based on an examination of a sample of Asian companies performing functions similar to the routine functions of XYZ-Asia it is determined that an arm's length return on XYZ-Asia's operating assets in the Stelon business is 10 per cent, resulting in a profit on those routine functions of \$20 million (10% x \$200 million) for XYZ-Asia's Stelon business, and a residual profit of \$180 million.</p> <p>(v) Since the first stage of the residual profit split allocated profits to XYZ-Asia's contributions other than those attributable to unique and valuable intangibles, it is assumed that the residual profit of \$180 million is attributable to the unique and valuable intangibles related to Stelon, i.e. the Asian brand name for Stelon and the Stelon formula (including XYZ-Asia's modifications). To estimate the relative values of these intangibles, the ratios of the capitalized value of expenditures as of Y1 on Stelon-related research and development and marketing over the Y1 sales related to such expenditures are compared.</p> <p>(vi) As XYZ's protective product research and development expenses support the worldwide protective product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide business activities to which they relate. It is determined that it is reasonable to allocate the value of these expenses based on worldwide protective product sales. Using information on the average useful life of its investments in protective product research and development, XYZ's protective product research and development expenses are capitalized and amortised. This analysis indicates that the capitalized research and development expenditures have a value of \$0.20 per dollar of global protective product</p>
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<p>development and marketing support only its sales in Asia. Using information on the average useful life of XYZ-Asia's investments in marketing and research and development the taxing authority capitalizes and amortizes XYZ-Asia's expenditures and determines that they have a value in 2009 of \$0.40 per dollar of XYZ-Asia's Stelon sales.</p> <p>(viii) Thus, XYZ and XYZ-Asia together contributed \$0.60 in capitalized intangible development expenses for each dollar of XYZ-Asia's protective product sales for 2009, of which XYZ contributed a third (or \$0.20 per dollar of sales). Accordingly, the taxing authority determines that an arm's length royalty for the Stelon license for the 2009 taxable year is \$60 Million, i.e. one-third of XYZ-Asia's \$180 Million in residual Stelon profit.</p>	<p>sales in the Y1 tax year.</p> <p>(vii) XYZ-Asia's expenditures on Stelon research and development and marketing support only its sales in Asia. Using information on the average useful life of XYZ-Asia's investments in marketing and research and development XYZ-Asia's expenditures are capitalized and amortized and from this it is determined that they have a value in Y1 of \$0.40 per dollar of XYZ-Asia's Stelon sales.</p> <p>(viii) Thus, XYZ and XYZ-Asia together contributed \$0.60 in capitalized intangible development expenses for each dollar of XYZ-Asia's protective product sales for Y1, of which XYZ contributed a third (or \$0.20 per dollar of sales) and XYA-Asia contributed two thirds (or \$0.40 per dollar of sales). Accordingly, it is determined that an arm's length split of the residual profits would see one third of those profits being allocated to XYZ and two thirds being allocated to XYZ-Asia.</p>
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<p>B.3.3.15. Comparable Profit Split Method</p>	<p><i>Comparable profit split method</i></p>
	<p>35. In some countries, reference is made to the comparable profit split method. This application of the profit split method relies on a comparison of the allocation of profits between independent enterprises engaged in comparable activities under comparable circumstances to those of the controlled transaction(s). That is, it relies heavily on external market data to determine how the relevant profits should be split between the related parties. As has been noted above, such information may be very useful, but is rarely available in practice.</p>
<p>B.3.3.15.2. The contribution analysis and the Comparable Profit Split Method are difficult to apply in practice and therefore not often used. This is especially the case because the reliable external market data necessary to split the combined profits between the associated enterprises are often not available.</p>	<p>[Delete]</p>

Determining the profits to be split

36. The relevant profits to be split under the profit split method are those which arise to the associated enterprises as a result of the controlled transaction(s) under examination. It will be important to consider the level of aggregation of transactions in this regard [insert cross reference] and then to examine the relevant income and expense amounts of each party in relation to those transactions.
37. In most cases, since the relevant profits will be comprised of income and expense amounts from more than one related party in more than one jurisdiction, the relevant financial data of the entities will need to first be put on a common basis, including with regard to the accounting practice and currency used. As this can materially affect the application of the method, consistency over time is important in this regard.
38. Other than in cases where the profit split covers all the activities of each of the related parties, the financial data will need to be segmented in accordance with the accurately delineated transaction(s) covered by the profit split approach. In cases where reliable product-line or divisional accounts are available, these may be useful to the determination of the relevant profits to be split.

Measures of profit

39. The profit split method is most commonly used to split net or operating profits. Applying the method in this way means that all the related parties are exposed to both the income and expenses associated with the relevant transactions in a consistent manner. However, depending on the accurate delineation of the transaction, other measures of profits may be appropriate. For example, if gross profits are split, each related party would then deduct its own operating expenses. Such an application may be appropriate where the parties do not share the risks associated with the operating expenses relating to the controlled transaction, but do share the risks associated with the volume of sales and prices charged, as well as those associated with the production or acquisition of the goods or services.

Example 8 [Measures of profit]

Accelory Corp designs, develops and manufactures complex industrial machinery products. A new generation of one of its key product lines uses an innovative powertrain system that was designed, developed and manufactured by TurboAcc Limited, an associated enterprise of Accelory. The system was tailored specifically for Accelory machines and would not be compatible with machines produced by other manufacturers without significant further modifications.

While Accelory Corp products are well established in the market and the company's products are considered to be market leaders in the sector, the innovative powertrain system developed by TurboAcc becomes a key selling point for the new generation of products. The success or otherwise of the new generation products relies to a significant degree on the performance of the powertrain systems made by TurboAcc.

The powertrain systems were developed entirely by TurboAcc. TurboAcc also assumed all of the risk in relation to the development of the systems, with no direct involvement by Accelory in the making of any significant decisions in this regard.

Accelory assumes all of the risks in relation to the overall production and sale of the new generation of products. In this example, although Accelory and TurboAcc each assume separate economically significant risks, those risks are highly interdependent. As a result, the profit split is found to be the most appropriate method. In this case, while the overall fortunes of the companies are highly interdependent, each company operates very independently and has no involvement in or control over the operations of

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the other. Therefore, a profit split of revenues from Accelory's sales of the product or the relevant gross profits of both Accelory and TurboAcc from the transactions may be the most appropriate way to apply the profit split method. In this way, each party will bear the financial consequences of the playing out of risks relating to their own operating expenses (and cost of sales in the case of a split of revenues).

Actual or anticipated profits

40. The profit split method is most commonly applied to split the actual relevant profits of the related parties in relation to controlled transactions. Since actual profits will reflect the playing out of the risks which affect the transactions, such a split will typically result in each related party being subject to those risks. It would thus be appropriate where the accurate delineation of the transaction shows that each related party shares such risks. For example, where the parties to the controlled transaction share the assumption of the economically significant risks, or separately assume closely-related economically significant risks in relation to the controlled transactions, it would be expected that a split of actual profits would apply.
41. On the other hand, where the profit split is found to be the most appropriate method but the accurate delineation of the transaction shows that one or more of the related parties does not share in the assumption of the economically significant risks, a split of anticipated profits is likely to be more appropriate.
42. A common application of an anticipated profit split is in the use of a discounted cash flow valuation technique, which might be used, for example, to determine the present value of a transferred intangible or other asset. For example, Company A transfers all the rights in a fully developed unique and valuable intangible, intangible X, to Company B, its associated enterprise. Company B has its own unique and valuable intangibles which are expected to complement intangible X. Company A expects to have no ongoing involvement in the exploitation of intangible X, as these activities will be wholly undertaken and controlled by Company B. In this case, assume it is determined that the profit split is the most appropriate method since both Company A and Company B make unique and valuable contributions. However, since Company A will not be involved in the ongoing exploitation of the intangible after the transfer, and it does not assume any risks relating to those exploitation activities, at arm's length, its return should not be subject to those risks. Instead, it should receive a share of the anticipated profits from the Company B's exploitation of the combined intangibles of Companies A and B, discounted to reflect its present value at the time of the transfer. This amount might be calculated using a discounted cash flow valuation technique which analyses the present value of the likely income from the exploitation of intangible X. The ongoing risks relating to the exploitation of the intangibles are solely assumed by Company B and no adjustment to the remuneration due to Company A needs to be made should the intangible actually be more or less successful than anticipated.
43. It should be noted that measures of profits which vary to some degree with the playing out of risks, without being fully exposed to such risk, can also be used. In all cases, the measure of relevant profits to be split should be aligned with the accurate delineation of the transaction in order to produce an arm's length outcome.
44. Even where a profit split of actual profits is used, the method should be applied without hindsight. That is, unless there are significant unforeseen developments which would have resulted in a renegotiation of the agreement had it occurred between independent parties, the basis for determining how the relevant profits should be calculated and how they should be split amongst the associated enterprises should ordinarily be determined based on information known or reasonably foreseeable at

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the time of, or prior to the transaction(s). This is the case even though it may only be possible to apply the actual calculations some time thereafter. For example, Company E and its associated enterprise, Company F are so highly integrated that the profit split method is found to be the most appropriate method to evaluate the controlled transactions between them. The way in which the relevant profits from their transactions should be determined is established ex ante, that is, at or prior to the time they engage in the transactions. At that time, they also determine that the residual profit split method of actual net profits should be applied, and that the residual profits should be split between them on the basis of the value of current year marketing expenses of each party, after having allocated basic or 'routine' returns on the routine sales and distribution activities conducted by both Companies E and F. In this example, the way in which the profit split method is to be applied is determined at the start of the period. However, the agreed method can only be applied at year end, once the amount of sales, marketing expenses, and the amount of the relevant actual net profits has been determined. If, in a subsequent period, these intra-group transactions are subject to a transfer pricing audit, the tax administration would not be precluded from examining the selection of the transfer pricing method or the way in which it was applied in order to confirm compliance with the arm's length principle. In doing this, the tax administration may also examine what information was actually known or reasonably foreseeable at the time of the transaction.

[The paragraph above has now been agreed by the Subcommittee.]

Profit splitting factors

45. The profit split method aims to determine transfer prices by reference to the manner in which independent parties would have divided profits amongst themselves had they engaged in comparable transactions. However, information on comparable profit splits or similar arrangements are often not available, so the method is more often applied by reference to some other measure of the relative contributions to those profits of each associated enterprise, as a way of approximating the outcome that would have been achieved between independent parties.
46. It would not be appropriate to provide prescriptive guidance as to the measure or measures to be used to split the relevant profits, as this will depend on the facts of each case. However, whatever factor(s) are selected, they should be capable of objective measurement and not themselves subject to non-arm's length pricing or valuation. The measures should also be verifiable and supported by data. While these considerations need to be borne in mind, amounts based on the taxpayer's own internal information (e.g. from their financial accounts) are commonly used.
47. In some cases, a multi-factor approach to splitting profits may be adopted. However, it may also be the case that a single measure of the key contributions to value of each enterprise to the transaction will be sufficient as a proxy for the relative value contributed.
48. In this regard, information from the functional analysis is likely to be particularly important. Other information in the taxpayer's Local file may also be useful. In addition, where the Master File is available, the information therein on key value-drivers, considered in the context of the business and industry environment, may also be helpful to the extent that the value drivers are for the transactions under examination are similar to those for the MNE group or business line that is the subject of the Master File.

[The paragraph above was amended following comments received on the draft.]

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49. Depending on the circumstances, profit splitting factors might be based on the value of (certain types of) assets or capital, where there is a strong correlation between tangible assets or intangibles, or capital employed, and the creation of value in the controlled transaction. In such cases, care should be taken to ensure reliable and consistent measures of the value of the asset(s) concerned.
50. In other cases, cost-based factors may be found to be appropriate, e.g. costs related to the unique and valuable contributions such as R&D, engineering, design, marketing, etc., or the development of unique and valuable intangibles. Note that although cost is often be a poor measure of the absolute value of unique and valuable intangibles, the relative costs incurred by each party may provide a reasonable approximation of the relative value of their respective contributions. In some instances, it may be appropriate to adjust the cost amounts, e.g. where they are incurred in different periods, to ensure they represent reliable measures of the respective contributions of each party.
51. Other examples of profit splitting factors could include incremental sales, employee remuneration or bonus payments, time spent, headcount, etc. Such factors may be found to be appropriate where they provide a strong and sufficiently consistent correlation to the creation of value represented by the relevant (residual) profits.

Example 9

<p>[From B.3.3.17.2.] ...</p> <p>Company A designs and manufactures electronic components and transfers the components to a related Company B which uses them to manufacture an electronic product. Both Company A and Company B use innovative technological design to manufacture the components and electronic product, respectively.</p> <p>Company C, a related Company, distributes the electronic products. Assuming that the transfer price between Company B and Company C is at arm's length based on the Resale Price Method, the Residual Profit Split Method is applied to determine the arm's length transfer price between Company A and Company B because both companies own valuable intangible property</p>	<p>Company A designs and manufactures electronic components, which it transfers to a related Company B. Company B uses the components to manufacture an electronic product. Both Company A and Company B use unique and valuable innovative technological designs, which they have each developed themselves, to manufacture the components and electronic product, respectively.</p> <p>Company C, a related Company, distributes the electronic products to unrelated customers. An arm's length transfer price for the transactions between Company B and Company C is determined based on the most appropriate method, the Resale Price Method. The Residual Profit Split Method is found to be the most appropriate method to determine the arm's length transfer price between Company A and Company B because the contributions of both companies are found to constitute unique and valuable intangibles.</p>
<p>B.3.3.17.3. In step 1 of the residual analysis, a basic return for the manufacturing function is determined for Company A and Company B. Specifically a benchmarking analysis is performed to search for comparable independent manufacturers which do not own valuable intangible property. The residual profit, which is the combined profits of Company A and Company B after deducting the basic (arm's length) return for</p>	<p>In step 1 of the residual analysis, a basic return for the respective manufacturing functions is determined for Company A and Company B. Specifically, a benchmarking analysis is performed to search for comparable independent manufacturers which do not own or use unique and valuable intangibles. The residual profit, which is the relevant profits of Company A and Company B in relation to the transactions after deducting the</p>

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<p>the manufacturing function, is then divided between Company A and Company B. This allocation is based on relative R&D expenses which are assumed to be a reliable key to measure the relative value of each company's intangible property. Subsequently, the net profits of Company A and Company B are calculated in order to work back to a transfer price</p>	<p>basic (arm's length) return for the manufacturing functions, is then split between Company A and Company B. It is found in this case that an economically valid way to split the residual profits would be based on relative R&D expenses, since these are found to provide a reliable measure the relative value of each company's unique and valuable intangibles. Subsequently, the net profits of Company A and Company B are calculated in order to work back to a transfer price.</p>
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Example 10 [profit splitting factors]

Company A is a designer, developer and manufacturer of construction and earthmoving equipment. Company B, an associated enterprise of Company A, has developed, by its own efforts a unique and valuable trademark and tradename to support the sale of the construction and earthmoving equipment. The brand developed by Company B hinges on the reliability of the equipment produced by Company A, as well as the extensive programme of customer support provided by Company B (including proactive maintenance, guaranteeing supplies of spare parts for equipment used in all, including remote, locations). A transfer pricing analysis determines that each party makes unique and valuable contributions and as a result, a residual profit split is found to be the most appropriate method. In determining how the relevant residual profits should be split, the key contributions of Companies A and B are considered. As a result of that analysis, reliable profit splitting factors based on those categories of R&D expenses (for Company A) relating to the unique and valuable intangibles embedded in the products; and marketing and customer support expenses (for Company B) are used.

Changes to other parts of the Manual:

Glossary of terms

Existing text of the Practical Manual	Proposed revised text
<p>Contribution analysis Where the profit split method is used, the contribution analysis requires the combined profit to be divided between the associated enterprises based on the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions.</p>	<p>Contribution analysis: Where a contribution analysis is used under the profit split method, the relevant profit from the transactions is divided between the associated enterprises based on the relative value of their contributions, e.g. their functions performed, assets used and risks assumed.</p>
<p>Profit Split Method The profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions.</p>	<p>Profit split method: The profit split method seeks to eliminate the effect on profits of non-arm's length conditions made or imposed in controlled transactions by determining the division of profits that independent enterprises would have expected to realise from engaging in the transactions.</p>

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<p>Residual profit split Under a residual profit split analysis the combined profits from the controlled transactions are allocated between the associated enterprises based on a two-step approach. In the first step, sufficient profit is allocated to each enterprise to provide basic arm’s length compensation for routine contributions. In the second step, the residual profit is allocated between the enterprises based on the facts and circumstances.</p>	<p>Residual analysis: Where a residual analysis is used under the profit split method, the relevant profits in relation to the transactions are allocated between the associated enterprises based on a two-step approach. In the first step, a ‘routine’ arm’s length profit for the basic or ‘routine’ contributions of each enterprise is determined, e.g. through the application of a one-sided method using information from uncontrolled transactions. In the second step, the residual profit remaining after deducting those ‘routine’ returns is split between the enterprises, generally based on their relative contributions.</p>
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Other references to the profit split method in the Manual

Existing text of the Practical Manual	Proposed revised text
<p>B.1.5.9. Profit-split methods. Profit-split methods take the combined profits earned by two related parties from one or a series of transactions and then divide those profits using an economically valid defined basis that aims at replicating the division of profits that would have been anticipated in an agreement made at arm’s length. Arm’s length pricing is therefore derived for both parties by working back from profit to price.</p>	<p>B.1.5.9. Profit split method. The profit split method takes the relevant profits earned by two or more related parties from one or a series of transactions, and then divides those profits on an economically valid 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 each party by working back from profit to price.</p>
<p>B.1.6.16. The Profit Split Method is typically used in cases where both parties to the transaction make unique and valuable contributions. However, care should be taken to identify the intangibles in question. Experience has shown that the transfer pricing methods most likely to prove useful in matters involving transfers of intangibles or rights in intangibles are the CUP Method and the Transactional Profit Split Method. Valuation techniques can be useful tools in some circumstances.</p>	<p>B.1.6.16 The profit split method may be the most appropriate method in case where both parties contribute unique and valuable intangibles. 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 intangibles are the CUP method and the profit split method. Valuation techniques can be useful tools in some circumstances.</p>

**ATTACHMENT D: REVISED TEXT ON SYNERGIES (CHAPTER B.5.2.28
AND NEW TEXT FOR CHAPTER B.1) (PART 1)
AND ADDITIONAL GUIDANCE ON CENTRALISED
PROCUREMENT ACTIVITIES (PART 2)**

PART 1: POTENTIAL REVISIONS TO CURRENT GUIDANCE ON SYNERGIES

[Note: Paragraph B.5.2.28 within the section on Intangibles begins a discussion relating to group synergies which is extended to procurement services, and gradations of intensity of such services. The Subcommittee agreed to limit the existing guidance to group synergies and to remove the references to gradations of intensity of procurement activities since procurement activities are now covered in more detail in the proposed additional guidance. Part 1 of this attachment includes a redrafted Chapter B.5.2.28)

Comprehensive guidance on procurement services is now contained in additional drafting at Part 2 of this attachment. What is therefore missing from the UN Manual is a more extended discussion of group synergies, and the principles that apply in a transfer pricing analysis. Such a discussion would seem appropriate to include in the introductory section of the Manual since it is an over-arching concept – Part 1 of this Attachment includes proposed drafting].

Group synergies and intangibles

B.5.2.28. Group synergies are not an intangible, but they can contribute to the level of income earned by an MNE group. Generally, because of the existence of an MNE group, the associated enterprises comprising such groups may benefit from interactions or synergies among group members which are not generally available to independent enterprises. Examples include streamlined management, elimination of costly duplication of effort, economies of scale, integrated systems, purchasing or borrowing power. This type of synergy does not constitute an intangible because it is not capable of being owned or controlled by an enterprise in accordance with the definition in B.5.2.3. However, group synergies can have an effect on the determination of arm's length conditions for controlled transactions, and Section B.1.XX provides guidance on the transfer pricing treatment of group synergies.

Group synergies and transfer pricing *[to be included in B.1.XX]*

1. MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies among group members which are not generally available to independent enterprises. As explained in the section on the theory of the firm, MNE groups are able to minimise their costs through their integration economies, which are not available to domestic firms (see A.2.7). Such group synergies can arise, for example, as a result of streamlined management, elimination of costly duplication of effort, economies of scale, integrated systems, purchasing or

borrowing power. Such group synergies are often favourable to the group as a whole and therefore may heighten the aggregate profits earned by group members compared to independent enterprises. In other circumstances, however, integration economies of MNE groups can lead to reduced competitiveness (see A.2.12). The MNE group may not have a competitive edge in performing functions in-house compared to outsourcing functions to specialised firms, the size and scope of corporate operations may create bureaucratic barriers not faced by smaller and more nimble enterprises, or one portion of the business may be forced to work with systems that are not the most efficient for its business because of group-wide standards established by the MNE group.

2. Section B.4.2.21-24 discusses passive association and incidental benefits in the context of intra-group services. The guidance explains that an associated enterprise should not be considered to receive an intra-group service or be required to make any payment when it obtains benefits attributable solely to being part of a larger MNE group. The benefits of association with an MNE group are not a chargeable service for the members of the MNE group. The key feature of this kind of incidental benefit is that it is passive and cannot be attributed to a deliberate concerted action taken by another member of the MNE group. On the other hand, a deliberate concerted action involves one associated enterprise performing functions, using assets, or assuming risks for the benefit of one or more other associated enterprises, such that arm's length compensation is required.
3. Whether group synergies exist, the nature and source of the synergistic benefit or burden, and whether the synergistic benefit or burden arises through deliberate concerted group actions can only be determined through a thorough functional and comparability analysis.
4. The difference between deliberate concerted action and benefits of passive association may be illustrated by the differences in the following scenarios. If a central purchasing manager at the parent company or regional management centre performs a service by negotiating a group-wide discount with a supplier on the condition of achieving minimum group-wide purchasing levels, and group members then purchase from that supplier and obtain the discount, deliberate concerted group action has occurred notwithstanding the absence of specific purchase and sale transactions among group members. Where a supplier unilaterally offers one member of a group a favourable price in the hope of attracting business from other group members, however, no deliberate concerted group action would have occurred. Instead the favourable price is a synergistic effect that may be a comparability factor relating to the economic circumstances of the group member. In the first scenario, the deliberate concerted action of negotiating a group-wide discount is a service that should be appropriately rewarded. However, the benefits of those large-scale purchasing synergies should typically be shared by the members of the group in proportion to their purchase volumes.

5. Another example relates to lower interest costs, as discussed further in Section XX. Company B may benefit from credit terms from third-party lenders because it is part of MNE Group ABC that are more favourable than those obtained by otherwise similar independent enterprises. Third-party lenders may conclude that Company B is less likely to present credit risk because the MNE Group is likely to support Company B and prevent default. However, the third-party lenders have obtained no explicit guarantees from MNE Group ABC. Company B, therefore, receives a passive, incidental benefit that cannot be attributed to a deliberate concerted action of any member of the MNE Group ABC. Instead the implicit support is a synergistic effect that may be a comparability factor relating to the economic circumstances of Company B. In contrast, if the parent company of MNE Group ABC, Company A, provides a formal guarantee to the third-party lenders as an inducement to offer enhanced terms to Company B, then Company A would be party to a deliberate concerted action in which it performs functions, uses assets, and assumes risks for the benefit of Company B, such that arm's length compensation is required.
6. The analysis of group centralised procurement activities will often require assessment of group synergies. Assume that MNE Group ABC decides to implement a policy of cost savings by centralising procurement functions in Company P. Company P acts to aggregate purchase orders for raw materials on behalf of group members, and thereby is able to take advantage of volume discounts that arise solely because of the MNE group's aggregated purchasing. The relevant associated enterprises of MNE Group ABC buy the raw materials at the price negotiated by Company P. In this scenario, Company P performs a deliberate concerted action for which an arm's length fee should be paid by the relevant associated enterprises benefitting from the procurement service. However, Company P is not entitled to retain any part of the discounts. Any volume effect on the price of raw materials is contributed by the buying power of the associated enterprises that allow Company P to aggregate their requirements for the goods. The volume benefit should accrue to the associated enterprises contributing the buying power, less the fee payable to Company P.
7. Section B.4.XX provides additional guidance on how to analyse centralised procurement activities, the factors that may affect compensation for those activities, and the transfer pricing methods that may be appropriate.

PART 2: ADDITIONAL GUIDANCE - CENTRALISED PROCUREMENT ACTIVITIES

Introduction

1. This section provides additional guidance on how to analyse centralised procurement activities in an MNE group, the factors that may affect compensation for those activities, and the transfer pricing methods that may be appropriate.
2. Additional guidance is appropriate because most MNE groups operate some form of centralised procurement, but the precise nature of the activities and their contribution to value can vary widely. This guidance helps to identify the functions that may be involved in centralised procurement activities, and the factors that can distinguish lower contributions to value from higher contributions. Developing countries sometimes encounter aggressive arrangements involving the insertion by an MNE group of procurement activities that seem to lack economic substance; in illustrating the commercial objectives of centralised procurement activities and typical functions, this guidance should help to identify features of substantive arrangements.
3. Procurement activities may attract the interest of tax administrations. These activities are among those specified for disclosure in a Country-by-Country Report¹ and are the subject of attention by the Forum of Tax Administrations in its Handbook on Effective Tax Risk Assessment, where procurement is seen as a potentially mobile activity that could be located outside key markets and used to reduce the level of taxable income in the jurisdictions where goods are processed or sold.² Offshore procurement is identified as a flag suggesting further investigation in Section C.3.3.2.19 (page 428) of this Manual.
4. However, procurement activities may be located outside key markets because the activity, or some element of it, needs to be conducted in close proximity to the sources of supply. For some industrial sectors, including clothing or food ingredients for examples, those sources of supply may be developing countries for whom the products may represent a significant proportion of export trade. Therefore, incorrectly evaluating procurement activities can have detrimental tax consequences for both the jurisdiction in which the activity generates income and also the jurisdiction being charged a fee. This guidance provides a framework in which to evaluate procurement activities, irrespective of their location, and its application is illustrated by an extended example at the end of the section (see paragraphs 51-55).

A preliminary note on cost-savings

5. Procurement activities are often associated with cost-savings, which is usually taken to mean per unit cost reductions of the goods or services procured. However, as the following section explains (see paragraphs 10-14), there may be many commercial objectives driving the centralising of procurement activities within an MNE group, and per unit cost-savings may not

¹ OECD (2015), *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
<http://dx.doi.org/10.1787/9789264241480-en>

² OECD (2017), *Country-by-Country Reporting: Handbook on Effective Tax Risk Assessment*, OECD, Paris.
www.oecd.org/tax/beps/country-by-country-reporting-handbook-on-effective-tax-risk-assessment.pdf. See paragraphs 70-71.

always be one of them. Procurement activities can and do provide value in ways other than per unit cost reductions.

6. Where evidence of per unit cost reductions is provided by a taxpayer, the impact of any volume effect will need to be considered, but it is important not to jump to the conclusion that the reductions are caused solely or partly by a volume effect. A supplier will not always be willing or able to reduce the price in exchange for higher volumes, and the associated enterprises individually may already have sufficient volume to command the lowest price. In the absence of a published price list, it will be difficult for tax administrations to assess whether additional volume has caused additional discount. There may be countervailing commercial pressures as well that drive a buyer to adopt a multiple sourcing strategy and to spread its volume around multiple vendors and reduce risk exposure, and similarly that may drive a vendor to avoid over-reliance on one customer.
7. Evidence of per unit cost reductions may point not to a potential volume effect, but to the interaction of the procurement activities with the vendor that helps to reduce the vendor's costs or risks which can then partly be passed on to the buyer: for example, a procurement company could be found to take on transport co-ordination functions, or could be found to assume compliance with labelling requirements. Significantly, procurement activities could be found to include arranging for a range of products to be sourced from a particular vendor, some seasonal, time sensitive, and with unpredictable demand, and some predictable items that can be produced throughout the year, so that the vendor can plan production schedules more efficiently and reduce or eliminate down-time and associated costs. Reduction in the vendor's risks and costs in this manner can drive a more favourable price for the buyer. In such a case, volume itself may play little or no part in achieving the cost reductions for the buyer; instead the cost reductions are achieved through the expert co-ordination of both vendor and buyer requirements by the party providing such procurement activities.
8. Measurement of per unit cost-savings is sometimes used in evaluating the fee for procurement activities, as discussed further in paragraph 41. This can be a difficult measurement for tax administrations to analyse. It may be possible to see that in Month 12 an MNE was paying 100 for an item, and that in Month 13 following the introduction of a centralised group procurement company, the MNE was paying 95 for the identical item on the same terms. But as time passes, the relevance of using 100 as the base-line reduces because other factors may have contributed to price changes, and the item may no longer be identical. In such cases, measurement of cost-savings in, say, Month 37 may be presented by the taxpayer based on comparison with a hypothetical price that the MNE would have paid in Month 37 had it not received the services of the group procurement company. The hypothesis will need to be presented rigorously by the taxpayer with supporting evidence, and verification ultimately may be difficult for tax administrations. Thus, where cost-savings are relevant to evaluating a fee for procurement activities they need to be supported by evidence that can be examined by tax administrations. It should not be forgotten that procurement activities can provide value in the absence of per unit cost reductions.
9. In practice, the MNE group may monitor and measure in various ways the performance of procurement activities for commercial purposes in order to assess its own effectiveness, and those measures may be instructive in a transfer pricing analysis. Depending on the commercial objectives of the MNE group, such monitoring and measurement may focus on quality, speed, standardising the range of items, finding alternative sources of supply, working capital management through vendor credit terms and inventory levels, order processing costs, production disruption, integrating other divisions or newly acquired businesses, meeting external and internal standards (for examples, ethical trading, traceability, safety), and specific improvement projects to which the procurement function contributes.

Commercial objectives in centralising procurement functions

10. There may be various commercial objectives in centralising procurement activities. A pure volume effect may not be the most important objective, particularly when MNEs in an MNE group may individually have strong buying power. At its simplest level centralising can reduce administrative costs by co-ordinating and aggregating purchase orders, so that instead of, say, 25 associated enterprises in an MNE group, each separately purchasing from, say, 10 suppliers, thereby creating 250 orders each time, the purchase orders are aggregated, so that there is only one order placed with each of the 10 suppliers. However, at this simple level, the individual MNEs continue to determine their requirements, and the central procurement activity helps to manage and reduce the administrative costs of order processing and accounts payable.
11. An additional commercial objective of centralising procurement activities might be to standardise buying terms; it may be that the 25 enterprises had each negotiated different terms with the suppliers in the past, and the oversight of all purchasing that central co-ordination can bring enables a sharing of the best terms for all associated enterprises. The central procurement function remains administrative; it is not itself creating enhanced terms but acting as the vehicle through which the MNEs share information and best practice. In some circumstances, dealing with one buyer may be helpful for the supplier since it is no longer dealing with 25 different buyers and may be able to share efficiencies with the MNE group that arise through reduction in numbers of purchase orders, standardisation of terms, and co-ordinated production scheduling and delivery.
12. In some industries, for example producers or users of energy products, centralising procurement activities may respond to the significant infrastructure costs required to perform the procurement activities. Such costs may involve electronic trading platforms and may also extend to transportation and storage assets. A key commercial objective in centralising procurement activities in such cases is to make the most efficient use of the investment.
13. In other situations, the centralising of procurement activities may be established, or may evolve, to take a more active and extensive role in managing procurement and sourcing for the MNE group with the objective of improving the group's profitability and managing its risks. The role may be directed to enhancing the relationship with vendors, to improving the performance of the associated enterprises requiring the goods or services, or both. A skilled buying team will likely analyse the supply chain and seek to rationalise excessive numbers of vendors without creating unacceptable exposure to a particular supplier, region, or currency; seek to deepen the relationship with remaining vendors through collaboration in managing production scheduling, demand forecasting, and specification improvements; monitor quality; select better or alternative sources of supply; and continually assess global trends that may affect availability of supply and prices. A skilled buying team may also seek to understand and anticipate the requirements of the associated enterprises using the goods or services. The buying team may work closely with the production teams or development teams of the associated enterprises so that the buying team can suggest alternative or cheaper components, and will seek to understand and contribute to scheduling forecasts in order to avoid the costs and risks of over-stocking as well as the potentially greater costs and risks of having insufficient supply. In some sectors there are regulatory requirements concerning traceability of items used in producing goods, and there may be consumer interest in sustainability, environmental impact, and ethical concerns which can have consequences for the reputation and ultimate success of the MNE group. The central procurement and sourcing function may have the commercial objective of co-ordinating or leading the efforts of the MNE group in these matters.

14. In fulfilling these more active and extensive roles, the central procurement activities are not simply administrative, but have the commercial objective of improving the performance of the MNE group's operations. Since such an objective for active and extensive procurement activities carries the potential for a higher evaluation of the arm's length compensation, then detailed explanation of the extent of the activities and how they contribute to the MNE group's performance will likely be covered in the taxpayer's transfer pricing documentation.

Evaluating compensation for procurement activities

15. Any evaluation of the compensation for centralised procurement activities in an MNE group should be based on a thorough understanding of the accurately delineated transaction, as set out in section B.2.3 (pages 70-109) of this Manual. Three matters are likely to be particularly important to understand: the role and expertise of a procurement services provider; the nature of the items procured and the commercial risks associated with those items; any risks that a service provider assumes. These matters are discussed in the following sections.

The role and expertise of the procurement services provider

16. Procurement activities cover a range of functions and the particular functions actually performed in a particular case need to be specifically identified and their commercial objectives and contribution assessed. In performing such an analysis, it can be helpful to consider two categories of functions relating to procurement: purchasing and sourcing.
17. In providing a purchasing service, a centralised group procurement company may be instructed by the associated enterprises about their requirements, and the instructions may include specifications for the product or service, identification of the vendors, and parameters for volumes, pricing, delivery scheduling and other terms. In performing such a purchasing function, a group procurement company may provide "execution only," and it may perform a largely administrative function relating to raising purchase orders and managing accounts payable. The role may not require expertise about the products or services procured, the needs of the recipients, or the capabilities of the vendors. The role of centralised purchasing may include relaying revised terms or other proposals to the recipients for approval, but it may not actively seek improvements or alternatives. The commercial objectives of a centralised purchasing function may include those outlined in paragraphs 10-11.
18. A sourcing role is more extensive. The role of the centralised procurement company in performing a sourcing function may involve working with the associated recipient enterprises jointly to draw up specifications, to explore alternative specifications, identify potential sources of supply taking into account advantages and disadvantages of particular sourcing strategies, work with vendors to understand their capabilities and options, propose supply schedule and other terms taking into account production forecasts. Such a role may require expertise about the products or services procured, the needs of the recipients, and the capabilities of the vendors. It is not an "execution-only" administrative role, but determines the sourcing strategy, and involves vendor management and demand forecasting. In addition to specialised know-how, such a sourcing activity may use proprietary software tools to evaluate vendors and manage supply scheduling and inventory levels. The commercial objectives of a centralised sourcing function may include those outlined in paragraph 13.

19. Functionality and expertise are greater in a sourcing activity than in an activity that is limited to purchasing. As a result, purchasing and sourcing would generally be more valuable to the recipient enterprises than a purchasing only service, and would be expected to command a higher amount of compensation than that for purchasing alone. Therefore, in evaluating a particular controlled transaction involving procurement activities, it is likely to be useful properly to understand the scope of purchasing activities and the scope of any sourcing activities.
20. Although purchasing functions have been considered separately to sourcing functions to highlight differences that may affect levels of compensation, in practice activities may include aspects of both categories. For example, a purchasing function may include aspects of sourcing activities with the result that the activity is not simply “execution-only,” and would thus generally be more valuable to the recipient enterprises in such a case than an activity limited to purchasing.

The nature of the items procured and the commercial risks associated with those items

21. It is important to determine through the accurate delineation of the actual transaction whether the goods or services procured by the centralised procurement company constitute core spend or non-core spend for the recipient associated enterprises. Non-core spend, sometimes referred to as indirect spend, covers goods and services that support the businesses of the recipient associated enterprises and are not themselves converted into a finished item or resold. Core spend, sometimes referred to as direct spend, involves items that are converted or resold in the course of the business of the recipient associated enterprises.
22. In the case of non-core spend for the recipient associated enterprises, for examples, stationery, office equipment, telephone services, vans, media space, an important factor that needs to be tested in accurately delineating the actual transaction is that the goods or services are unlikely to be a key risk for the recipient or a significant contributor to business performance. The goods and services are likely to be available from a range of suppliers, and so the pricing is already competitive. Specifications are likely to be relatively standardised and options for changes or improvements may be limited. The function of the centralised procurement company in the case of non-core spend may be largely that of a co-ordinator and aggregator, with the main commercial benefits being the combining of purchasing power across the MNE group and efficiencies in reducing administrative costs for the MNE group.
23. However, in the case of spend on core business-critical items, for examples, lithium for a battery manufacturer, certain ingredients for a food manufacturer, energy for a smelter, an important factor that needs to be tested in accurately delineating the actual transaction is that the goods or services may represent a significant contribution to business performance and be associated with significant risks. The items may have very limited sources, availability of supply may be unpredictable, prices may be volatile, and there may be particular specifications to be met or worked around. The function of the centralised procurement company in the case of core spend may require specialised expertise and may involve mitigation of critical business risks for the recipient associated enterprises.
24. These factors suggest that procurement of goods and services constituting business critical core spend for the recipient associated enterprises would generally be more valuable to the recipient enterprises than procurement of goods and services constituting non-core spend, and, subject to thorough determination of the actual functions performed, assets used, and risks assumed in a specific controlled transaction, would generally be expected to command a higher amount of compensation than that for procurement of indirect spend.

Risks assumed by the group procurement company

25. Arguments are sometimes made that a centralised procurement company should have a high level of compensation because of the risks it claims to assume. While it is the case that the assumption of increased risk would be expected to be compensated by an increase in the anticipated return, careful attention may need to be paid when examining risk assumption by the associated enterprise performing centralised procurement activities.
26. It may be asserted that a centralised procurement company assumes, for example, risk associated with holding inventory (which may involve the risk of changes in the value of inventory owing to market price changes or obsolescence, or the risk of additional costs because of over-stocking), since it is the contracting party that buys the goods or services procured and is the contracting party that sells them to the recipient associated enterprises. The insertion of the centralised procurement company in the flow of goods or services is not likely to be a typical arrangement given the potential for additional cross-border movements and complexities of customs duties and additional transaction costs. In addition, vendors may require guarantees to be provided by the parent or associated enterprises in order to sell directly to a group procurement company that may present concerns about creditworthiness; in such a case, there may be additional intra-group transactions to be examined. Where inventory is determined to be owned by the centralised procurement company, evaluation of the risk is required. It will be relevant to determine whether the group procurement company takes “flash title” only under back-to-back arrangements with the associated recipient enterprises, and thus significantly reducing or eliminating its inventory risk. In practice the recipient associated enterprises may compensate the centralised procurement company for any additional costs, thus insulating the centralised procurement company from the impact of inventory risk. It will also be relevant to consider whether the supply arrangements with the vendors are flexible so that purchase volumes can be reduced as demand falls, thus reducing or eliminating risk. Nevertheless, if the centralised procurement company could suffer additional costs as a result of the impact of inventory risk it contractually assumes, then control of risk under the guidance in section B.2.3.2.23-46 (pages 87-100) needs to be determined. If the centralised procurement company does not control the inventory risk it contractually assumes because, for example, it does not determine quantities purchased, stocking levels, production scheduling, or manufacturing volumes, then it is unlikely to be allocated the risk under that guidance for transfer pricing purposes.
27. A centralised procurement company may assume contractually a range of other risks. In such cases a similar analysis to that described above under the guidance in section B.2.3.2.23-46 (pages 87-100) is required. A procurement company could claim to assume price risk by undertaking to guarantee a certain range of prices for the recipient associated enterprises, or to assume volume risk by undertaking to supply a certain volume. However, such risks may be reduced or eliminated if the terms agreed with the vendors in practice pass price or volume risk back to the vendors. A claim that a centralised procurement company is exposed to the full impact of cyclical demand and price risks should be examined carefully, as attention should be paid to whether it has the expertise to evaluate the risk, makes decisions in relation to the risk, and has the financial capacity to bear the risk.
28. Although the group procurement company may not assume risks associated with the goods and services procured, it will be necessary to determine whether the group procurement company performs control functions relating to risks assumed by associated enterprises, since such risk control functions need to be taken into account in determining the appropriate amount and form of the compensation (see paragraphs B.2.3.2.43-45 in particular, page 98). In the case of the sourcing of core, business-critical items, in particular, the accurate delineation of the actual transaction could show that availability of supply is a key risk for the MNE group and that the group procurement

company directly mitigates disruption risk through developing reliable sources of supply or exploring alternative specifications.

29. Thus, as a general matter, recipient associated enterprises would be prepared to pay more for a procurement service that reduces or eliminates their risks, but care needs to be taken to ascertain that risks have been mitigated for the recipient associated enterprises, and that the group procurement company contributes to such mitigation by performing risk control functions.
30. A centralised procurement company may have its own risk associated with developing and maintaining proprietary tools, systems, know-how, and investment in physical assets.

Procurement from associated enterprises

31. Until now in this guidance it has been assumed that the most typical form of intra-group procurement activities involves procurement from independent vendors on behalf of recipient associated enterprises. It is possible, however, that an MNE group may use a group procurement company to purchase from other associated enterprises in the group. The potential for reducing transaction costs and increasing efficiency through co-ordination and aggregation could apply in such a case for the MNE group similar to the situation described in paragraph 10. Instead of dealing with 10 independent suppliers, as illustrated in that paragraph, the group procurement company could deal with 10 associated enterprises, but the efficiency effect of consolidating the ordering process and reducing the number of purchase orders continues to apply.
32. However, a claim that a group procurement company performs more than an administrative role when acting as an intermediary in purchasing from associated enterprises may not be supported by the evidence. A claim that a group procurement company performs a sourcing role, involving the selection and management of vendors which are associated enterprises, is likely to be difficult to substantiate in the case of an integrated MNE group in which associated enterprises are aware of the capabilities of each other and are organised to fulfil a specific role in the MNE group's supply chain. That supply chain may benefit from other centralised management activities, but any payment for finding a vendor that is already found and is part of the design of the MNE group's supply chain would seem difficult to justify.

Pricing methods

33. The general principles set out in Section B.4 relating to the pricing of intra-group services apply to pricing considerations for intra-group procurement services, including the application of the direct and indirect charging approach (see B.4.3.5-9). In general, where the centralised procurement activity provides services to multiple associated enterprises in the MNE group, and the services to each associated enterprise can be separately analysed and quantified, then a direct charge approach may be reliably applied. However, in many instances of centralised procurement activities that provide services to multiple associated enterprises, there may be no option but to use an indirect allocation of the fee to those associated enterprises. An appropriate allocation key may be based on respective values of goods or services procured for those associated enterprises. Care should be taken in applying an indirect allocation of the fee to ensure that all the associated enterprises receive the same kind of service. For example, it may be that the procurement activity provides a purchasing service for some associated enterprises but a purchasing and sourcing service for others; or it may be that the procurement activity relates to non-core spend for some associated enterprises but to core spend for others. In such instances, there may be different levels of fee required depending on the category of services. It is important that any indirect allocation of the fee takes

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these differences into account by, for instance, identifying the associated enterprises using the same category of services and allocating an indirect share of the fee relevant to that category of services only to those associated enterprises.

34. Given the range of activities that may be involved in procurement and sourcing activities, it may not be surprising that a range of pricing structures are seen in arrangements with independent outsourced procurement providers. These range from a fee related to the provider's input costs, which may be particularly appropriate where the decision to outsource is motivated by a desire to reduce headcount and transfer people and associated costs to the outsourced provider; fees which are set as a percentage of managed spend (similar to a commission), and which may encourage investment by the service provider; to fees which are designed to incentivise the outsourced procurement provider by sharing gains. In practice hybrid fee structures may be seen, combining a commission on managed spend with a gain-share element.
35. When determining the pricing for centralised procurement activities within an MNE group, transfer pricing methods can broadly mirror such industry pricing structures. Pricing based on costs, plus an arm's length mark-up under the Cost Plus Method or TNMM, may be appropriate; or comparable commission rates under a CUP Method may be applied; or a form of benefits analysis may be constructed which requires the gains achieved as a result of the procurement activities to be measured and which then shares them between the centralised procurement company and the associated recipient enterprises.
36. As in any transfer pricing analysis, the appropriateness of the method depends crucially on the facts and circumstances of the controlled transaction and the reliability with which the method can be applied. These matters are discussed further below, but before doing so it is useful to remember that the application of one method rather than another method can yield significantly different results, especially if applied over a number of years. Take the following example of a centralised procurement activity, which shows the costs incurred in performing the activities ("own costs") and the costs of the goods or services procured through those activities ("managed spend"):

Table 1

	Year 1	Year 2	Year 3
Own costs (A)	\$5m	\$10m	\$10m
Managed spend (B)	\$200m	\$800m	\$1600m
<i>Cost Plus approach</i>			
Illustrative fee based on Cost Plus Method (A plus 10% mark-up)	\$5.5m	\$11m	\$11m
Profit	\$0.5m	\$1m	\$1m
Fee expressed as a percentage of B	2.75%	1.375%	0.6875%
<i>CUP approach</i>			
Illustrative fee based on CUP (B x 2% commission)	\$4m	\$16m	\$32m
Profit	(\$1m)	\$6m	\$22m
Fee expressed as a mark-up on A	N/A	160%	320%

37. For the purposes of the example, it is assumed that a Cost Plus Method determines a mark-up of 10% and that a CUP determines a commission on managed spend of 2%.
38. In this example, there may have been some over-capacity or some investment in technology by the centralised procurement company in its initial year that meant a CUP method results in a loss. However, as managed spend ramps up, the gap between profits under the Cost Plus Method and profits under a CUP Method widens considerably. One method determines a 10% mark-up on costs, the other method results in a 320% mark-up; one method determines a commission of 2%, the other method results in a commission of less than 1%. Expressed another way, the recipient associated enterprises in Year 3 pay \$32m to the centralised procurement company under one method and \$11m under the other method. A high standard of evidence and analysis is usually required, therefore, to demonstrate that the centralised procurement company contributes sufficiently to business outcomes to justify the payment of that additional \$21m. Because the choice of method can lead to widely different outcomes, disputes between taxpayers and tax administrations about the pricing of centralised procurement services may focus on differences of view about the appropriate method.
39. A Cost Plus Method or TNMM is likely to be an appropriate method where the procurement activities are mainly purchasing rather than sourcing, and any sourcing activity is limited in scope or relates to non-core spend, largely execute instructions from the recipient associated enterprises, and do not assume risks or perform risk control functions relating to the goods or services procured. In such a case the value to the MNE group is mainly efficient deployment of resources and a cost-based fee may appropriately measure that value. The arm's length mark-up may reliably be based on comparable independent service providers. As for many intra-group services that require to be benchmarked against independent services providers, identical activities may be hard to identify. Nevertheless, it is expected that independent services providers can be identified that provide broadly similar administrative services that would provide a sufficiently reliable range of mark-ups. The Cost Plus Method should not necessarily be rejected even if the activities are more extensive and require greater resources, greater expertise, and perhaps investment in tools and software. In such a case, the cost base for the centralised procurement company is likely to be greater, and a mark-up on that greater base will generate a higher fee.
40. However, where the procurement activities involve significant sourcing activities, relate to core goods and services, include business-critical decisions, and involve some risk assumption or performance of risk control functions, then the activities affect business outcomes and the value to the MNE group may correlate to revenues or profits. The reliability of comparing the centralised procurement company to independent service providers under a Cost Plus Method may be reduced. Instead, the application of arm's length commission rates under a CUP Method is likely to be appropriate.
41. In other situations, there may be differences between the uncontrolled and controlled procurement activities; for examples, the items procured may relate to non-core spend rather than to core, business critical items, and the relationship between rates of commission and volumes may not be reliably ascertained. The reliability of the application of a CUP Method can be improved in these situations by using the concept that at arm's length recipient parties will be prepared to pay a fee if they expect to receive benefits from the outsourced procurement services provider that are greater than the fee. In practice, therefore, the information about commission rates resulting from a CUP Method can be interpreted and tested for reasonableness by an approach which seeks to identify the benefits derived from the procurement activities, and to share them between the centralised procurement company and the recipient associated enterprises based on their respective contributions, including any risk control functions. The identification of benefits should not be

speculative or created for the transfer pricing analysis, but should be rooted in commercial measures that the MNE group uses to assess performance (see the illustrations in paragraph 9). If benefits are not measured by the MNE group independently of a transfer pricing analysis, then this may suggest that the benefits are not commercially important and the activity is not one that makes a significant contribution to business performance (and consequently may suggest that a Cost Plus Method is more appropriate). Care should be taken in such an analysis first to measure and deduct benefits arising from aggregation of volumes, which should be allocated to the associated enterprises contributing the buying power. The resulting share of benefits can corroborate commission-based fees and narrow the range of fees potentially identified through a CUP analysis. Evidence of gain-share agreements between independent parties can be difficult to use if it is not possible reliably to determine how the parameters for measuring the gain have been set in uncontrolled arrangements, and how those parameters might be adapted to apply to the controlled arrangement.

42. The following is an example of how the results of a CUP Method can be interpreted, tested for reasonableness, and corroborated by an approach which shares benefits. Assume that a centralised procurement activity of Company A is responsible for sourcing and for managing the purchasing process for the core spend of a related manufacturing company, Company B. Company B purchases the goods directly from the suppliers sourced by Company A, and so any price discounts attributable to Company B's volume accrue directly to Company B. Both companies are part of the ABC Group. The spend managed by Company A represents 80% of Company B's costs of goods. Company A incurs costs of 5 in performing its procurement activities. Company B sells its finished products to third parties; the products are technologically advanced, but the manufacturing process itself is not unique. Assume that the comparability analysis has determined that Company A's activities contribute significantly to the business performance of Company B and involve Company A using its know-how to work closely with suppliers to improve specifications, monitor quality, evaluate alternative sources of supply, and ensure uninterrupted supply. Recently the ABC Group has made public commitments to recycle and re-use components, and Company A has led the initiative with suppliers to make the necessary changes and achieve the Group's targets. The management of ABC Group monitors closely the performance of Company A through key performance indicators of Company B's business and risks including inventory levels, production down-time through supply problems, product failures in quality checks, and recycling targets. Good performance by Company A can positively contribute to the revenues, costs, and therefore profits of Company B; poor performance risks adversely affecting the profits of Company B.
43. Assume further that a CUP Method is appropriate. Potentially comparable commission rates in uncontrolled transactions are identified that provide a range between 1% and 7% of the managed spend. There are differences between the potential comparable and the activities of Company A, particularly because the comparable tend not to procure business-critical items nor assume responsibility for delivering key initiatives in the way that Company A does, and it is not possible reliably to determine how volume may affect the commission rates.

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44. Assume that Company B's significant financials show the following:

Sales to third parties			1000	
Cost of Goods	(500)			Managed Spend by Company A is 400. Potential CUP range of 1%-7% equates to a procurement fee of 4 to 28
Other Costs	(300)			
Total Costs		(800)		
Profits before procurement fee			200	
		<i>Application of corroborating benefits share approach as described in the following paragraphs.</i>		
		(80)		Benchmarked return to manufacturing
			120	Residual profits attributable to Company B's technology and Company A's procurement activities
		(5.25)		Routine procurement fee to Company A (own costs of 5 plus a mark-up of 5%)
Residual Profits			114.75	
Hypothetical technology royalty of 10%			(100)	Company B has developed the technology embedded in the product. A relief from royalty valuation approach determines the hypothetical royalty payments that would be saved through owning the asset, as compared with licensing the asset from a third party.
			14.75	Profits earned by Company B relating to procurement activities of Company A

45. The profits before procurement fee of 200 are earned from Company B's manufacturing activities, to which Company A contributes through its procurement activities. However, Company B's manufacturing activities are enhanced by the investment that it has made in research and development resulting in the technological advances in the products. Company A has also made investments in intangibles, particularly in developing its know-how and proprietary systems. Assume that returns to routine manufacturing can be benchmarked at cost-plus 10%. Applying that mark-up to total costs of Company B of 800 would give a profit of 80, leaving a residual of 120. Assume also that returns to routine procurement services can be benchmarked at cost-plus 5%, determining a routine fee to Company A on its costs of 5 of 5.25. The residual profit of 114.75 is attributable to Company B's technology and Company A's additional contribution to the business performance of Company B. At this point it may be possible to share the residual profit of 114.75 in proportion to the investment of the two companies in intangibles if it is determined that the categories of investment by Company A and Company B are sufficiently similar in potential value to makes such a sharing reliable. As an alternative, assume that the value of Company B's technology can reliably be estimated by determining the royalty payments that would be payable at arm's length if Company B did not own the technology but had to license it from a third party. The valuation results in a royalty of 10%. The resulting profits of 14.75 are therefore profits earned by Company B which relate to the additional contribution to its business performance from the procurement activities of Company A.

46. How the resulting profits of 14.75 should be shared between Company A and Company B may be possible to evaluate from the metrics ABC Group uses to monitor Company A's performance. This would likely require converting to an impact on profits the stated performance measures relating to inventory levels, production down-time through supply problems, product failures in quality checks, and recycling targets. Conversion would likely require assumptions to be presented about base-line performance and placing a value in terms of profits on variations to the base-line. Such an analysis may be informative but may not be definitive.
47. Failing that some reasonable estimates need to be made in order to share the resulting profits of 14.75 between Company A and Company B. The analysis would immediately suggest that paying 28 to Company A (a commission of 7% at the top of the CUP range on managed spend of 400) would attribute more than the residual to procurement activities (Company A is already attributed a routine return of 5.25, and so an additional 22.75 to arrive at a total fee of 28 would allocate nearly twice the residual to Company A). Instead the analysis suggests that a commission rate nearer the lower end of the potential CUP range is more appropriate. If all the residual of 14.75 were allocated to Company A, then the maximum commission would be 5% (calculated as the residual of 14.75 together with the routine return of 5.25 resulting in a procurement fee of 20, which is 5% of managed spend of 400). Paying 8 to Company A (representing a commission of 2.0% on the managed spend of 400) is towards the lower end of the CUP range, but would seem to represent a more reasonable share of residual profits between the two companies given the fact that it is Company B that bears the majority of risks. Under the benefits share Company A has already been allocated 5.25 and the additional 2.75 represents approximately a 20/80 split of the residual profits of 14.75 in favour of Company B.
48. Note that a fee of 8 in this example represents a mark-up of 60% on Company A's own costs of 5. Such a mark-up is significantly in excess of, for example, the rate of return for Company B's manufacturing activities. Such a relatively high mark-up does not undermine the outcome of this example. The example is intended to be an illustration of the guidance in paragraph 40 which states that "where the procurement activities involve significant sourcing activities, relate to core goods and services, include business-critical decisions, and involve some risk assumption or performance of risk control functions, then the activities affect business outcomes and the value to the MNE group may correlate to revenues or profits. The reliability of comparing the centralised procurement company to independent service providers under a Cost Plus Method may be reduced. Instead, the application of arm's length commission rates under a CUP Method is likely to be appropriate." The example shows how, in circumstances where a CUP Method is likely to be more reliable than a Cost Plus Method, the potentially wide ranges of commission rates under a CUP Method can be narrowed, tested for reasonableness, and corroborated through the application of an approach which shares benefits.
49. In summary, replication of pricing structures used by independent outsourced procurement services providers is rarely an option that can be adopted in practice because of the difficulties in finding such data, in interpreting it reliably in the context of the controlled arrangement, and in estimating appropriate adjustments. The Cost Plus Method or TNMM can be applied in most cases, even in cases where the centralised procurement company provides expert services and employs know-how and proprietary tools. Where the activities contribute significantly to commercial performance of the MNE group and involve control of economically significant risks for the MNE group, other methods may be appropriate. Commission rates in third-party arrangements may be available, with the result that a CUP Method can reliably be applied. Indicative commission rates under a CUP Method may be corroborated by an approach which shares accurately measured commercial benefits between the group procurement company and its associated enterprises. Reasonable

estimates can be made under a benefits share approach to interpret and test the appropriate positioning in the range of commission rates indicated under the CUP Method.

50. This guidance sets out guiding principles when one method might be more appropriate than another in approximating the fee that the parties would have agreed had they been independent. An understanding of the principles is necessary so that relevant distinctions of fact can be identified and conclusions consistent with those distinctions reached. The application of those principles is important where there can be significantly different outcomes depending on the method selected. The scope of significantly different outcomes is illustrated in paragraph 36; the example is a contrived one but the point is likely to be relevant for procurement activities when the amount of managed spend is so high relative to the cost of performing the activities that the gap in outcomes of the two approaches cannot reasonably be bridged through adopting, for example, high mark-ups under one method and low commission rates under another method. However, in practice, it may not always be the case that there is a significant gap, and there is usually little point in being dogmatic about the appropriate method if convergence of outcomes of each method is possible. Nevertheless, the example in paragraph 36 is also a reminder that while convergence might reasonably be achieved in Year 1, this would represent short-term pragmatism. The difference in outcomes does not remain static, and Year 2 and Year 3 indicate that a principled approach is required so that the relevant distinctions of fact can be made to determine which method is more appropriate in approximating the arm's length fee, as outlined in this guidance.

Extended example

51. The following extended example is designed to illustrate application of the guidance in this section by demonstrating the role and expertise of the procurement service providers, the nature of the items procured and the associated commercial risks, the risks assumed or controlled by the group procurement companies, and the transfer pricing implications.

Assumed facts of the example

52. An MNE group involved in the manufacture of food products has centralised procurement activities in two companies, Company A, based in Europe, and Company B, based in Africa. The operations of the two companies are different, as described below, and lead to different conclusions about the application of reliable pricing methods.
53. Company A employs 50 personnel and it operates to enhance standardisation of products and services supplied to the group by independent vendors, and to provide better oversight and control of costs. Analysis shows that about 60% of the spend it manages on behalf of the group involves non-core spend relating to procurement of packaging, logistics services, production machinery, information technology and communication equipment and services, and office equipment and supplies. In fulfilling its activities in relation to spend on non-core items it liaises with other group companies to understand their needs, sources and selects vendors, develops relationships with vendors, and negotiates terms. In practice packaging vendors regularly communicate directly with the group's Head of Development and also with production personnel located in the group's manufacturing plants to discuss innovations, cost reductions, and regulations. As a result, the role of Company A in relation to procurement of packaging is to place orders to already agreed specifications and with already selected and known vendors. The group recently experienced supply problems following a change in its supplier of logistics services following a tendering process organised by Company A. In accordance with the group's management controls, the decision to approve the new supplier was taken by the parent company with reference to analysis provided by Company A. The remaining 40% of the spend it manages on behalf of the group

relates to core spend on food ingredients. However, for these items Company A acts as a coordinator and aggregator of orders, as notified by other group companies, and performs the administrative functions of order processing and accounts payable. Company A assumes no risk in relation to the goods and services it procures and does not control significant risks. The performance of Company A is measured by its management on the basis of its order processing costs.

54. The MNE group depends on the sustainability and quality of key ingredients and another group company, Company B, provides procurement and sourcing functions for these core items. This company needs constant contact with sources of supply, and is based in Africa. It has 20 employees. The employees develop relationships directly with growers, and provide guidance on growing techniques to improve yields and quality. To increase the security of supply, Company B finds growers in new regions willing to use the technological know-how Company B provides. Company B works closely with production companies in the group to forecast demand as a result of changes in consumer preferences, and also with the group's development function in order that it can anticipate demand for sourcing of new ingredients. Company B's activities are critical to the group's performance and to control of economically significant risks. The performance of Company B is measured by its management with reference to uninterrupted supply for the MNE group and mitigation of the effects of price volatility for the MNE group. Company B reports regularly to the parent company about trends, sourcing opportunities and risks, and will seek approval for investment in new regions. Company B also fulfils the group's regulatory requirements in terms of traceability of the items it sources. Company B performs administrative functions of order processing and accounts payable, except for larger volume purchases, the details of which are referred to and processed by Company A.

Interpretation of the assumed facts for transfer pricing purposes

55. Company A performs a useful function for the group, but it would not seem to be a highly valuable one that contributes significantly to business performance. Company A performs an "execution-only" administrative function in relation to spend on business-critical core items, based on decisions made elsewhere in the group. In relation to spend on non-core items, these are not business-critical items, they are largely standardised and can be sourced from a range of readily identifiable suppliers competing on price. The fact that a new logistics services supplier caused supply problems for the group is not something that Company A is responsible for, assuming its organisation of the tendering process was not negligent. Where deep knowledge of the products sourced is required, in the case of packaging, Company A has no role, except to process orders.
56. If Company A were compensated through a commission fee (by reference to a percentage of spend under management) based on an application of a CUP Method that resulted in profits many multiples of its own cost base, then in the absence of further evidence concerns would arise about why its activities justify such a valuation. There would also be concern in the absence of appropriate evidence if compensation for Company A included a share in savings made by the MNE group based on its activities. The performance of Company A is not measured by management by reference to savings, the calculation of any savings would require a high standard of evidence, and Company A does not seem to have any specialised input or control any risks that would justify a sharing in any savings in the event that they could be reliably measured. A Cost Plus Method seems more likely to be appropriate on the facts presented, subject to the reliability with which the method can be applied in any given case.

57. Company B is a smaller operation than Company A in terms of headcount but it concentrates on business-critical aspects that can directly affect group profitability. Company B is deeply involved in developing sources of supply for core items and in working with its associated production companies in forecasting and meeting their demand. It helps to control economically significant risks for the group through influencing continuity of supply and resistance to price volatility, and the group measures its performance in managing these risks.
58. If Company B were compensated through a fee based on its costs plus a mark-up benchmarked by comparison with independent companies, there might be concerns about the reliability of the comparison, and particularly whether the potentially comparable independent companies take responsibility for the sourcing of core, business critical items for their clients. The outcome of a Cost Plus Method may understate the value created by Company B as measured by the MNE group. On the facts presented, it is more likely that a method which takes into account the contribution to value by Company B would be appropriate. Commission rates in third-party arrangements may be available, with the result that a CUP Method can reliably be applied. Indicative commission rates under a CUP Method may be corroborated using an approach which shares benefits based on management's commercial measurements of savings.

**ATTACHMENT E: PROPOSED TEXT ON GENERAL LEGAL ENVIRONMENT,
TRANSFER PRICING LEGISLATION DESIGN AND PRACTICAL
IMPLEMENTATION OF A
TRANSFER PRICING REGIME**

**C.1. GENERAL LEGAL ENVIRONMENT FOR ESTABLISHING AND UPDATING
TRANSFER PRICING REGIMES**

C.1.1. Introduction

C.1.1.1. Background

C.1.1.1.1. Transfer pricing rules were introduced in domestic legislation by the United Kingdom in 1915 and by the United States in 1917. However, transfer pricing was not an issue of great concern until the late 1960s when international commercial transactions expanded greatly in volume. The development of transfer pricing legislation was historically led, in terms of implementation, by developed countries. In recent years, due to the growth and complexity of international “transfers” within MNEs, both developed and developing countries are introducing legislation to address transfer pricing issues. See Chapter B.1., paragraph B.1.3. for more on the evolution of transfer pricing rules.

C.1.1.1.2. Domestic transfer pricing legislation worldwide shows some harmonization in basic principles, in accordance with the arm’s length standard, even if the application is not identical across jurisdictions. The introduction of transfer pricing rules has taken place within different legislative traditions, and in the context of the sovereign right of countries to address taxation matters. The reasons why there has been a great deal of consistency in approach include:

- The benefits of similar approaches between countries in terms of avoiding double taxation or double non-taxation.
- The broad acceptance of the arm’s length principle as the best current alternative for dealing with transfer pricing issues; and
- Many countries have adopted the UN or OECD forms of Article 9 in their bilateral tax treaties and have therefore already committed to its fundamentals.

C.1.1.1.3. With the increase in cases where tax authorities have made adjustments to transfer prices set by related entities, taxpayers increasingly seek practical dispute resolution mechanisms to avoid double taxation. As a result, mutual agreement procedure (MAP) discussions as set out in bilateral treaties¹ are evolving as a more effective mechanism through supplementary domestic regulations, as well as through increased practice regarding the management of the MAP.

1 Based upon Article 25 of both the UN and OECD Model Conventions.

C.1.1.1.4. Many countries have implemented advance pricing agreements (APAs) in their legal and/or administrative procedures as a bilateral resolution mechanism to avoid double taxation. Other countries have introduced an arbitration procedure to give certainty that a dispute will be resolved. The advantages and disadvantages of these solutions are dealt with in Chapter C.4.; however, the application of these solutions will be influenced by the legal environment of each country, and thus will take place in a variety of ways.

C.1.1.2. Key Considerations in the Design of a Transfer Pricing Regime

C.1.1.2.1 This chapter reviews the legal environment of transfer pricing legislation in a global context and seeks to identify the key practical issues from the perspective of developing countries. It should be emphasized that there is no “template” or model legislation that works in every situation. Transfer pricing legislation has to be appropriate to the needs of a particular developing country. This means that any legislation of another country which is examined as a source of ideas should be considered closely as to why it has worked or has not worked in its original context, including ease of practical administration of and compliance with the rules it contains. Those reasons and the “environment” of the legislation should be compared with those in the country introducing transfer pricing rules. This analysis will help indicate what notions or concepts, if any, of the provisions is relevant to, adequate for, and could work effectively in the conditions of a particular country.

C.1.1.2.2. It is important that drafters of transfer pricing legislation take into account the outcomes of the BEPS Project, especially regarding Actions 8, 9, 10 and 13 (8—Intangibles; 9—Risks and capital; 10—Other high-risk transactions, and 13—Transfer pricing documentation and country-by-country reporting).² These issues tend to have a more harmonized legal approach in a post-BEPS Project era.

C.1.1.2.3. Having taken into account the legislative design considerations, this chapter also addresses the practical implementation of transfer pricing rules in a particular jurisdiction. As such, guidance is provided on:

- How the considerations and the substantive issues regarding legislative design can be implemented in a national transfer pricing regime through laws and subsidiary regulations;
- How national transfer pricing regimes relate to domestic tax laws;
- The position of transfer pricing rules within the overall framework of international tax rules within that domestic regime; and
- How to keep the newly implemented transfer pricing regime updated, and administer it on a daily basis.

C.1.1.2.4. The chapters that follow in Part C then deal in depth with specific areas of implementation and administration. Chapter C.2. covers the documentation requirements central to a transfer pricing regime, transparency issues and exchange of information, in an increasingly complex business environment [discussed in detail at Part A]. Chapter C.3. discusses transfer pricing audits and provides guidance on approaches to managing audit programmes and capacity. Chapter C.4. provides detail and approaches to dispute resolution techniques, including how to access dispute resolution systems. Chapter C.5 then brings together these issues for a tax administration in a developing country to provide approaches to build capacity within the tax administration. Part C thus aims to provide a set of approaches by which a tax administration

2 Reports available at <http://www.oecd.org/tax/beps/beps-actions.htm>.

in a developing country can introduce and sustain a transfer pricing regime that meets international standards.

C.1.1.3. Domestic Transfer Pricing Legislation: Structural Overview

C.1.1.3.1. As already noted in Chapter B.1., “transfer pricing” is essentially a neutral concept. However, the term is often used, incorrectly and in a pejorative sense, to mean the artificial shifting of taxable income from one company within an MNE, to another company of the same group, in another jurisdiction, through incorrect transfer prices. The aim of such practices is to reduce the overall tax burden of the group. This issue involves the setting of a transfer price; as such, the problem is not that a “transfer price” had been set (as there must be in such a transaction, however legitimate) but that the price set is not at arm’s length. Consequently, the matter is referred to in this Manual as “transfer mis-pricing”. See Chapter B.1., paragraph B.1.1.7., for examples.

C.1.1.3.2. Many countries have introduced specific domestic tax rules to prevent possible tax base erosion through mis-pricing of transactions between related parties. As noted above, this legislation is almost invariably proposed as being in accordance with the arm’s length principle. The arm’s length principle is generally accepted as the guiding principle for allocating income not only among related entities (group companies) but also among cross-border units of a single entity. Under the arm’s length principle, it is necessary to conduct a comparability analysis of third-party transactions. However, where the taxpayer fails to provide the tax authority with the required information to enable it to determine an arm’s length price in particular circumstances, some countries have adopted a presumptive taxation method (discussed in para. B.8.7. below). This is generally subject to rebuttal by the taxpayer, who may present counter-evidence to show the results as being at arm’s length.

C.1.1.3.3. Another approach to transfer pricing income allocation is referred to as global formulary apportionment (GFA), see Chapter B.1., paragraph B.1.4.14. for further information. However, such a system cannot operate at a global level, in a way that fully avoids double taxation, without prior global agreement on a suitable uniform formula, which has not yet been achieved. This Manual addresses transfer pricing rules based on the arm’s length principle. Most developing countries, almost invariably, accept the arm’s length principle as the basis of their bilateral tax treaty provisions on related party transactions and in their domestic legislation addressing the same issues. This Manual does not deal with the advantages and disadvantages, in the longer term, of other possible alternative ways of dealing with transfer pricing, including GFA.

C.1.1.4. Key Considerations in the Design of the Transfer Pricing Regime

[C.1.1.4.1. Some countries have formally recognized the guidance provided in the Manual in their domestic law. For example, in Tanzania *The Tax Administration (Transfer Pricing) Regulations 2018* provides that the transfer pricing regulations are to be interpreted in a manner consistent with the arm’s length principle in Article 9 of the UN Model Convention and the Manual. The Regulations also provide that the regulations are to be interpreted in a manner consistent with Article 9 of the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines.

C.1.1.4.2. Another example is Zimbabwe which enacted transfer pricing legislation in 2016. These provisions formally recognize the OECD Transfer Pricing Guidelines and the Manual are recognized as guidance documents.]

C.1.1.4.3. Two different broad approaches may be seen in domestic legislation relating to transfer pricing. Both of these seek to implement an arm's length approach in relation to controlled transactions.

C.1.1.4.4. The first possible legislative approach simply authorizes the tax administration to distribute, apportion or allocate gross income, deductions, credits etc. when they determine that such distribution, apportionment or allocation is necessary in order to prevent tax avoidance or clearly reflect the income of any organizations, trades or businesses.³ Under this system there is no reference to the taxpayer's compliance obligation in determining the arm's length price, while the arm's length principle may be stipulated in either the general legislative principle or within regulations or secondary legislation supporting the primary legislation.

C.1.1.4.5. The second legislative approach stipulates that, based on the self-assessment system, any foreign affiliated transaction shall be deemed to have been conducted on an arm's length basis for tax purposes if that transaction is not in fact conducted at arm's length.⁴ In other words, a non-arm's length transaction is reconstructed as an arm's length transaction for the purposes of calculating taxable income and taxing such income. This legislative approach effectively requires that taxpayers to conduct their initial tax accounting based on the arm's length principle.

C.1.1.4.6. A country's choice between the two alternatives will relate to the basic principles of domestic tax law in that country. This will include issues such as the form of anti-avoidance legislation, time limits for application of the legislation, and where to place the burden of proof. However, the choice of styles of domestic legislation has made no substantial difference in the legal procedure of implementing the arm's length principle. The manner in which arm's length methodologies are stipulated in each country's legislation differs to some extent, as described below.

C.1.1.4.7. Depending on the legal system of the country concerned, tax laws may set out in great detail issues such as the definition of related parties, transfer pricing methodologies, documentation, penalties and the procedures for advance pricing agreements/arrangements (APAs). Other countries might opt only to identify the basic structure of tax base allocation among the related parties under the arm's length principle. In the latter case, detailed practical guidance should normally be available in subordinate legal materials, such as regulations, administrative rules and public notices. Therefore, even if such matters are defined in great detail in the primary tax law, there is a need to provide clear operational guidance. Tax administrations should consider the level of guidance available in their countries, and determine if further detail is needed.

C.1.1.4.8. There remains substantial risk of double taxation even when two countries follow the same general arm's length principle approach. For example, such double taxation may occur where specific guidance on the implementation of the arm's length principle is different from one country to another, and countries do not bridge this gap with any specific understanding or interpretative guidance. The following paragraphs demonstrate potential significant differences in domestic law which may result in major differences in how countries interpret or apply the arm's length principle.

C.1.1.5. Associated Enterprises

C.1.1.5.1. The definition of which persons (companies, trusts, individuals and other entities) and therefore transactions are covered by transfer pricing legislation is a key issue since the arm's length principle applies to transactions between related parties. Article 9 of both the UN and OECD Models considers enterprises to be "associated" (i.e. "related parties") if one of the enterprises meets the conditions of Article 9,

³ E.g. US Internal Revenue Code §482.

⁴ E.g. Japan Special Taxation Measure Act §66-4(1).

Subparagraph 1(a) or 1(b) with respect to the other enterprise. These subparagraphs cover so-called parent-subsidiary relationships and brother-sister relationships as relevant situations.

C.1.1.5.2 The requirement of control in each subparagraph is defined as being to “participate directly or indirectly in the management, control or capital of an enterprise”. There is no specific common guidance on this matter either in the Commentaries on Article 9 in the UN and OECD Models, or in the OECD Transfer Pricing Guidelines. This is mainly because transfer pricing issues are relevant only if special conditions have been made or imposed between two parties. Thus, the degree of control as a threshold for triggering transfer pricing legislation has in effect been left to domestic legislation.

C.1.1.5.3. Some countries apply a 50 per cent shareholding threshold as the degree of participation required for “associated” status; some countries employ a lower threshold. However, countries with higher thresholds usually employ substantive rules on control as a fallback, or subsidiary, test. These may focus on elements other than shareholding, such as dependency of input materials, distribution networks, voting rights, entities included in consolidated financial statements, financial resources and human resources in relation to other group members. There is thus no significant difference among countries on this matter.

C.1.1.5.4. Differing threshold criteria can result in disputes in certain circumstances. For example, in Japan, domestic law stipulates that a shareholding of 50 per cent or more is the threshold for an “associated enterprise”, which is generally a possible target of transfer pricing examination by tax authorities. This may bring into the examination “net” a 50/50 joint venture project organized by two independent parties.⁵

C.1.1.5.5. In South Africa, transfer pricing rules are applied to cross-border transactions between related persons, i.e. connected persons. A connected person is defined in relation to natural persons, trusts, members of partnerships and companies. Companies could be connected persons based on prescribed criteria including if one of the companies holds at least 20 per cent of the equity shares or can exercise at least 20 per cent of the voting rights in the other company. As an additional example, in Brazil the threshold of ownership is 10 per cent of the company’s equity, and this also applies when a person (individual or company) owns at least 10 per cent of the equity of the two companies involved in the transaction (the Brazilian company and the foreign company), as the TP legislation also applies the concepts of the Company Law. Brazilian TP legislation is very broad regarding the concept of “related persons”, e.g. it also considers the kinship of the individual resident in the foreign country performing commercial relations with companies in Brazil that are controlled or managed by his or her relatives (depending on the kinship grade); and all transactions performed with listed jurisdictions (low-tax and non-cooperative jurisdictions) are deemed related persons.

C.1.1.5.6. For developing countries, analysis of control might be an important challenge in ensuring that their transfer pricing legislation can be administered effectively. In addition, factors for identifying control should be carefully examined because evaluation of those factors requires complicated fact-finding procedures which might differ depending on industry sector, geographic characteristics, product cycle, etc.

C.1.1.6. Coverage of Transactions, Availability/Priority of Transfer Pricing Methods and Compliance

C.1.1.6.1. Transfer pricing generally covers all cross-border transactions involving a country, regardless of whether participants are residents or non-residents. Thus, transactions conducted between a permanent establishment (PE) of a foreign company located in a jurisdiction and its affiliate company located in

⁵ An equal-footing arrangement is generally not understood to pose a high risk of income-shifting, although there could still be some room for non-arm’s length pricing.

another jurisdiction are also subject to transfer pricing rules under the domestic law of that jurisdiction. In contrast, a transaction between a domestic PE of a foreign company and its affiliated company located domestically may not be subject to the transfer pricing rules in certain jurisdictions, such as Japan, because there is no substantial risk of income shifting beyond their borders, see Chapter C.1., paragraph C.1.1.3. for further information.

C.1.1.6.2. However, transactions between local branch offices and their headquarters may be regulated by other legislation, such as non-resident/foreign company taxation rules, and may be affected by Article 7 of bilateral tax treaties (usually based upon the UN or OECD Models). Although under such circumstances the arm's length principle should generally prevail in an equivalent manner, the legal framework of taxation should be differentiated. For example, the dispute resolution mechanism might be different depending on each country's domestic law and the relevant treaty. Nevertheless, in general, the same domestic transfer pricing legislation may be applicable both to transactions between a local branch (PE) and its headquarters (see Article 7 of the UN and OECD Models), and to transactions between associated enterprises (see Article 9 of the UN and OECD Models), despite the fact that a tax treaty between the countries involved in the transaction may be applicable.

C.1.1.6.3. The choice of method, availability of different types of methods and the priority to be given to various different transfer pricing methods are matters often covered by domestic legislative frameworks. Availability and priority of the transfer pricing methods is one of the most important elements for domestic legislation. This is often done through administrative guidance or other subsidiary materials instead of the tax laws. Many countries have followed the OECD Transfer Pricing Guidelines, as well as the UN Transfer Pricing Manual in developing their domestic legislative frameworks, and have adopted the traditional transaction methods as well as the transactional profit methods when establishing whether a transfer price was at arm's length. See further a detailed discussion of the methods in Chapter B.3., including that there is no longer considered to be a "hierarchy" of methods and that the most appropriate method should be applied.

C.1.1.6.4. Ease of administration is another important issue in the design of legal frameworks. Documentation requirements supported by penalties for non-compliance are the main instruments used by tax authorities for collection of sufficient information to test whether or not taxpayers have established an arm's length result. Preparing transfer pricing documentation can result into significant compliance costs for MNEs, especially if there are differences in countries' requirements. There is value in seeking to align documentation requirements with those of other countries, especially in the same region, unless there are good reasons in terms of reducing compliance and collection costs, or specific features of local legislation, that require differences.—Action 13 of the OECD/G20 BEPS Project specifically focused on transfer pricing documentation and country-by-country reporting, and guidance has been published on the implementation of relevant measures.⁶ Regarding transfer pricing documentation and country-by-country reporting guidance, refer to Chapter C.2.

C.1.1.6.5. Some differences in the coverage of transactions or in the legal form (statutes with penalty provisions or administrative guidance on self-assessment) will remain. It is therefore appropriate to continuously evaluate documentation and penalty legislation for effectiveness and proportionality. The

⁶ See OECD (2015): OECD/G20 Base Erosion and Profit Shifting Project: "Transfer Pricing Documentation and Country-by-Country Reporting: Action 13": 2015 Final Report available at: http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report_9789264241480-en#.V-N2wfCa0dU; further guidance was issued in 2016, available at <http://www.oecd.org/tax/beps/beps-actions.htm>.

experience of countries that have introduced transfer pricing rules may be relevant to developing countries just starting to introduce legislation and requirements in transfer pricing.

C.1.1.7. Burden of Proof

C.1.1.7.1. The burden of proof in tax litigation refers to the necessity of affirmatively proving the truth of facts alleged by a litigant on a preponderance of evidence. It is also sometimes referred to as “the risk of non-persuasion” or the “burden of persuasion”. A party meets this burden by convincing the fact-finder to understand the facts as they are proposed by that party. The party with this burden stands to lose if its evidence fails to convince the judge during a trial. A concept that precedes, but is different from, the burden of proof is “the burden of allegation”, which means a party’s duty to plead a matter in order for that matter to be heard in the lawsuit. A litigant needs to satisfy both the burden of allegation and the burden of proof to win a lawsuit.

C.1.1.7.2. The burden of proof operates in litigation. However, it is important to be able to identify the party with the burden of proof, where there is an obligation to comply with the arm’s length principle, during a tax audit exercise or when transfer pricing assessment is made because the case may ultimately end up in court.

C.1.1.7.3. The burden of proof for transfer pricing litigation may be determined in accordance with the burden of proof rules of civil procedure or tax litigation in general. If there are many court decisions on transfer pricing, the burden of proof for transfer pricing cases may be formulated in more detail through those precedents, depending on the general status of precedent in that jurisdiction. The burden of proof rules for transfer pricing cases differ among countries. The position that the taxpayer bears the burden of proof is taken, for example, by Australia, Brazil, Canada, India, South Africa and the United States.

C.1.1.7.4. In several countries the burden of proof rests originally on the taxpayer as they are obliged to prepare, maintain and present documentation demonstrating that the terms and conditions of its related-party transactions are consistent with the arm’s length principle.

C.1.1.7.5. Once the taxpayer discharges this burden, then it shifts to the tax authorities to evaluate and prove if the controlled prices have been determined in accordance with the arm’s length principle or if the information or data used in the computation is reliable or correct. Therefore, countries may assess and determine transfer pricing adjustments in the following situations:

- The related-party transaction was not determined in accordance with the arm’s length principle.
- The taxpayer did not supply sufficient information or proof to properly examine the related party transaction.
- The taxpayer did not present tax returns.
- The arm’s length price cannot otherwise be determined.

C.1.1.7.6. Subsequently, the burden of proof returns to the taxpayer in order to explain and document if the assessment is wrong, unfounded or unreasonable, and to confirm that the related-party transaction was conducted at arm’s length. This situation can occur as part of an audit process or in defense procedures (e.g. litigation process).

C.1.1.7.7. Tax administrations and taxpayers may encounter several challenges in meeting their respective burdens of proof. As a practical matter, associated enterprises normally establish the conditions for a transaction at the time the transaction is undertaken. In auditing these transactions, the tax administration may have to engage in a verification process perhaps some years after the transactions have taken place. Moreover, at some point the associated enterprises may be required to prove that these transactions are

consistent with the arm's length principle. As a part of the due diligence process, the arm's length principle may result in a compliance burden for the taxpayer and an administrative burden for the tax administration in evaluating significant numbers and types of the transactions. The tax administration would review any supporting documentation prepared by the taxpayer to show that its transactions are consistent with the arm's length principle. The tax administration may also need to gather information on the comparable uncontrolled transactions and the market conditions at the time the transactions took place, for numerous and varied transactions. Such an undertaking usually becomes more difficult with the passage of time. In such instance, both taxpayers and tax administrations often have difficulty in obtaining adequate information to apply the arm's length principle.

C.1.1.7.8. It should be noted that in practice the burden of proof is not always a deciding factor. The burden of proof requirement nevertheless plays an important role in deciding who should disclose what. Since burden of proof is a general issue emanating from the law of each country, the issue of whether the taxpayer or tax administration has the initial burden to prove that the pricing is in accordance with the arm's length principle should be handled within the domestic legal framework.

C.1.1.8. Presumptive Taxation Approaches and the Arm's Length Principle

C.1.1.8.1. A "presumptive taxation" approach has been provided for in the laws of some countries. Presumptive taxation provisions give tax authorities the power to "presume" an arm's length price based on information gathered by the authorities, and to reassess the taxpayer's taxable income on that basis. Such provisions are generally only regarded as applicable in case of the taxpayer's failure to provide relevant documentation on the arm's length price within a reasonable time (such as when information is requested of a taxpayer during an audit). Presumptive taxation is usually provided for as a last resort.

C.1.1.8.2. This methodology may be common in legislation related to domestic taxation and transfer pricing adjustments. However, transfer pricing adjustments in relation to foreign transactions generally create a risk of international double taxation and may be contentious. Most countries may therefore structure such legislation carefully in a manner consistent with the arm's length principle. However, it seems that some countries lower the threshold for applying this methodology, at least in terms of establishing comparable transactions.

C.1.1.8.3. The effectiveness of presumptive taxation depends on the of the approach adopted by the country concerned options i.e. the choice between self-assessment and being assessed by the authorities/tax administration). Under a self-assessment system, where the tax authorities always have the burden of proof whenever they propose an adjustment, presumptive taxation may appear more attractive. On the other hand, in an anti-avoidance focused system where taxpayers have an initial burden of proof on the authorities' adjustments, a penalty system may play a more effective role than presumptive taxation.

C.1.1.8.4. Another issue closely related to presumptive taxation, but relevant to other systems also, is the use of "secret comparables". Once examiners make an inquiry into third party transactions, the acquired data relating to those transactions is generally confidential under the tax laws, because the information is provided by such third parties under conditions of confidentiality. Therefore, during the dispute procedure, the taxpayers in relation to whom presumptive taxation is applied cannot access any materials which form the basis of the presumptive taxation. In order to secure an opportunity for taxpayers to defend their position against such taxation, the OECD Guidelines and the UN Transfer Pricing Manual advise that it would be unfair to apply a transfer pricing method on the basis of such secret comparables unless the tax administration is able, within the limits of its domestic confidentiality requirements, to disclose such data

to the taxpayer. Disclosure of the data would provide an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts.

C.1.1.9. Transfer Pricing Information Requirements

C.1.1.9.1 As a policy choice, governments should decide when, how and in what format they want to receive transfer pricing information. The form should be the most convenient format for the tax administration to process and respond to the information received, if required.

C.1.1.9.2. Disclosure requirements included in legislation may be part of the regular submission of annual returns, at the end of accounting/assessment periods, or be required as a result of the conclusion of a transaction. In these cases, taxpayers are required to inform the tax administration of the existence of a related party transaction, and to provide the details of that transaction.

C.1.1.9.3. On the other hand, the legislation may require the taxpayer to retain the information and provide it upon request. In that case the taxpayer has the responsibility to have adequate documentation to prove that the transaction was effected at arm's length if required or challenged by the tax administration.

C.1.1.9.4. An example of information requirements on transfer pricing in filing the annual income tax return is the related party transactions reporting form. A specific example is the Australian International Dealings Schedule that must be filed with the annual corporate income tax return. Another example is the Brazilian Corporate Income Tax Return (Declaração de Informações Econômico-Fiscais da Pessoa Jurídica, (DIPJ)) where the taxpayer is required to report all transfer pricing transactions taking place within a period or annual basis (depending on the taxpayer's reporting schedule). Taxpayers are required to report certain transactions with non-residents as they arise through these forms. The South African transfer pricing questionnaire, required to be submitted with the annual corporate tax return, is another relevant non-OECD example.

C.1.1.9.5. The mandatory disclosure of information is the most suitable option for tax administrations with capacity constraints—it may, as a result, be the preferred option for a developing country with limited resources to gather taxpayer information. Under this option, it is important for the regulation in force to make disclosure of information a function of the transfer pricing legislation so that the obligation to report derives directly from the main legislation (without any additional administrative requirements). That will provide tax administrations with taxpayer information which would allow them to better target audit procedures. Tax administrations should make sure they have human and technological resources in place to be able to process and benefit from this information, as well as balance the information request with the level of burden to taxpayers.

C.1.1.9.6. Countries such as Portugal, Mexico and Nigeria have established in their domestic legislations a threshold for producing transfer pricing documentation. As an example, in Portugal, companies with a turnover up to EUR 3 million⁷ are not required to maintain contemporaneous transfer pricing documentation.

C.1.1.10. Balance to be Struck between Statute and Subsidiary Regulations

C.1.1.10.1. As mentioned in C.1.1.1. above, some tax systems contain a general recognition of the basic aspects of a tax obligation, and then issue extensive regulations explaining how the rules would apply in

7 G. Teixeira & R. Tavares de Pina, Portugal - Transfer Pricing, Topical Analyses IBFD (accessed 23 Nov. 2018).

practice. For the purposes of this chapter, this essentially means recognizing the arm's length principle and the basic principles applicable to transfer pricing through the primary legislation.

C.1.1.10.2. There are some countries where all of the transfer pricing system is disclosed through statute legislation without its inclusion on subsidiary regulations. Therefore, given its hierarchy of a core law, the regulations are binding on the taxpayer and the tax administration.

C.1.1.10.3. In some jurisdictions the substantive provisions, foundations and determinations to observe the arm's length principle are included in the statute laws and then extensively regulated in subsidiary regulations. Depending on the hierarchy, there are countries in which supplementary regulations have the weight of law and, therefore, the obligation to observe transfer pricing rules and the determination on how to observe it is mandated by the regulations and, therefore, are binding for tax authorities and taxpayers.

C.1.1.10.4. Sometimes domestic tax systems are not able to confer the appropriate weight of authority to the accompanying regulation (as a result of the way the domestic tax system is organized or the legal system), but the bulk of the regulatory provision is, nevertheless, only prescribed through administrative guidelines (circular letters) which may be binding for the tax authorities, but not on the taxpayers who, in theory, can tax-plan around those rules. Therefore, the taxpayer can rely on those rules but not bound by them.

C.1.1.10.5. Developing countries should assess which system is most suitable considering their own domestic tax legislation and the level of complexity they want to assume through the application of the transfer pricing legislation. Objective statutory provisions tend to provide greater certainty because they are binding on taxpayers and the tax administration. They are also likely to provide fewer margins for dispute, making the system clearer, which in turn puts less pressure on already limited human resources from the tax administration. Consideration should also be given on the status of rulings; e.g. in Australia they are administratively binding on the tax administration, but not on the taxpayer.

C.1.1.11. Transfer Pricing Organization in Tax Administration

C.1.1.11.1. An important part of implementing a transfer pricing regime is determining which part of the tax administration should undertake transfer pricing work. The generally observed options are:

- Creating a transfer pricing department or division, tasked with the responsibility to handle all transfer pricing work arising from the application of the rules;
- Placing the transfer pricing work within an international operations group within the tax administration; or
- Considering compliance with the transfer pricing regime a part of the compliance responsibility of all taxpayers subject to these rules, and seeking to train all officers who are likely to face transfer pricing issues.

C.1.1.11.2. In addition to one of the three options above, tax administrations also have the option of creating specially designated departments within other departments, to deal with high profile cases, special cases or with certain groups of taxpayers. In this case, countries might also consider creating the following sub-departments:

- Placing the work within a LTU/LTO (Large Taxpayers Unit/Office) and building up capacity of officials working within that office in transfer pricing.

- Developing transfer pricing capacity in specific industry focused units which the tax administration considers to be particularly susceptible to transfer mis-pricing—e.g. pharmaceuticals, oil and gas, automotive, etc.

C.1.1.11.3. The choice to be made by a particular country will depend on its particular circumstances and capacity. The choice may also be dynamic, i.e. as capacity is developed along the lines suggested at Chapter C.5. For example, in the early stages of the regime being implemented, the transfer pricing work can be concentrated in the part of the tax administration that deals with international tax issues. As capacity is built and more cases are seen, a new section can be created within the LTU/LTO where the most high profile cases may be expected to emerge. Over time, more specialist knowledge can be built up and spread wider across the tax administration. See further Chapter C.3.2. for a detailed discussion on audit capability.

C.1.1.11.4. Taxpayer segmentation have been implemented across the world, which allows the tax administration to create centres of competence dealing with separate taxpayer types. Such units are often part of a reformed administration that includes structuring the administration along functional lines, focusing on the taxpayer as the administration's "customer". A principal objective of taxpayer segmentation is the minimisation of compliance costs. It is quite common to allocate the transfer pricing inspection division to the LTU/LTO, which is then considered the central repository of experience.

C.1.1.11.5. Such an allocation of responsibilities can foster evolving and increasing learning approaches. A good example is Brazil where the transfer pricing programme in the LTO (known as the DEMAC) focuses its audits mainly on specific sectors such as pharmaceuticals and automobiles. However, as the audit teams grew in sophistication in their approaches, and as they grew in number and experience, the focus became broader.

C.1.1.11.6. Finally, the design of a good tax administration must include an effective audit programme capable of detecting and penalizing non-compliant taxpayers. Such an audit programme could grow out of a larger compliance team, and could include industry and/or issues-oriented audits, comprehensive regular audits of specific businesses that fall within risk criteria and fully fledged tax fraud investigations. Joint investigation programmes to deal with suspected cases of non-compliance for corporate income tax and GST may also be planned by more sophisticated tax administrations. See further Chapter C.3.

C.1.1.11.7. Open consultation with business and stakeholders prior to implementation or modification of a particular piece of legislation may help create more common understanding between the taxpayer and the tax administration. This will help avoid potential future disputes by allowing time for taxpayers to foretell the issues that might cause greatest concern in the proposed legislation.

C.1.1.11.8. Use of information and communication technology (ICT) in tax administration is now a central part of capacity development. Tax administrations should consider use of ICT to increase transparency in the tax system and to automate processes. An increase in transparency means making information more readily available, without the need for personal contact. The automated communications system can provide relevant stakeholders with online access to templates, case studies, step-by-step guidelines (even if informal guidelines of no legal status), explanation of legislative changes, publication of pre-selected information geared towards specific industries or types of taxpayers (e.g. information pertinent to small and medium enterprises, separate information for large taxpayers, one for car makers, pharmaceuticals, etc.). Automation of processes would include introduction or extension of electronic filing of transfer pricing related compliance obligations, and possibly the use of trusted third party platforms. These measures have the potential to significantly reduce business compliance costs, improve taxpayer confidence and increase simplicity; they may also support anti-corruption initiatives and improve perceptions.

C.1.2 Transfer Pricing Rules in National Tax Regimes

C.1.2.1. Domestic Rules

C.1.2.1.1. Article 9 (Associated Enterprises) of the OECD and UN Models sets out the basic conditions for transfer pricing adjustments and for corresponding adjustments where there is a risk of double taxation. Although Article 9 advises the application of the arm's length principle it does not set out detailed transfer pricing rules. The Article is not considered to create a domestic transfer pricing regime if this does not already exist in a particular country. Countries must therefore formulate domestic legislation to implement transfer pricing rules. Generally, countries apply their domestic transfer pricing rules to cross-border transactions but some countries opt to apply transfer pricing rules also to domestic transactions. For such countries, this might be in recognition of the fact that their domestic tax bases can also be eroded through domestic transactions between related parties within the country, particularly where there are a number of different tax regimes in the jurisdiction (e.g. certain types of businesses or transactions that may be subject to different tax rates or special rules). Therefore, it is worth considering that when designing transfer pricing legislation, attention may also need to be ~~is also~~ given to compliance with the arm's length principle for transactions between related parties within a given jurisdiction. See B.1.7. for an exhaustive discussion of the substantive principles in this regard.

C.1.2.1.2. Another aspect worth taking into account when introducing or updating domestic transfer pricing legislation relates to the time lag between the elaboration and presentation of an initiative of legislation and its approval by the legislative bodies and entrance into effect. Nevertheless, since a few years ago and due to the sudden increased attention given to international tax matters by the BEPS project, including transfer pricing, countries have been able to introduce changes in their legislation in a rapid and effective manner.⁸

C.1.2.1.3. As mentioned in C.1.1.5., there are variations between countries in the definition of an "associated enterprise" based on factors such as the domestic legal system and circumstances of the country. The definition often uses a number of factors such as a minimum shareholding level or effective control of financial, personnel, trading conditions or other factors. There may also be a de minimis criterion under which related party transactions only come within the transfer pricing rules if they reach a certain amount. Although international consistency in the definition of associated persons and application of the arm's length principle is beneficial, each country must design its transfer pricing legislation in a way that is consistent with its legal and administrative framework, treaty obligations and resources. This can also be an evolutionary process; as the country develops its transfer pricing regime, it will also need to ensure that the administrative rules in, for example, a Taxes Management Act are simultaneously kept up to date.

C.1.2.1.4. Some countries may include safe harbour rules to exempt taxpayers who have met certain criteria from the need to comply with specific aspects of the transfer pricing rules. This reduces taxpayer compliance costs, increases certainty and also reduces costs of tax collection. The tax administration can focus audit resources on higher risk cases in terms of revenue at stake and risk of non-compliance. Safe harbours may however encourage tax planning and avoidance if the magnitude is not and are incompatible with the arm's length principle. There is also a risk of double taxation and double non-taxation where rules differ between countries. For further discussion see section B.1.7.5.

⁸ We believe that the relevance of including this paragraph lies on its reflection of current/actual challenges faced by tax administrations regarding time constraints in the context of presentation and approval of legislative initiatives.

C.1.2.2. Safe Harbour Rules

C.1.2.2.1. Safe harbour rules are rules that apply to a category of transactions, allowing a defined category of taxpayers to follow a simplified transfer pricing rules, or by exempting taxpayers from the application of the transfer pricing rules or from the application of transfer pricing documentation rules, as discussed later. Ideally safe harbour rules approximate outcomes under the arm's length principle to avoid double taxation or double non-taxation, or create market distortions. These rules could be limited to taxpayers with a magnitude or amount of controlled transactions below a threshold amount, expressed as a percentage or in absolute terms. The safe harbour rule can be relied upon by a taxpayer as an alternative to a more complex and burdensome rule, such as applying transfer pricing analysis, including a search for appropriate uncontrolled comparables. There are other types of simplified mechanisms for transfer pricing that certain countries also categorize as safe harbours. For example, another simplified mechanism sometimes used enables a company (generally smaller businesses or those with only limited international transactions) to avoid making a transfer pricing adjustment or having to keep transfer pricing documentation. A safe harbour is normally an obligation made available at the option of a taxpayer—it is generally regarded as a condition that the taxpayer can choose to apply or not. Other simplified or prescriptive rules which operate similarly to safe harbour rules, but which operate on a presumptive basis rather than at the option of the taxpayer, may also apply.

C.1.2.2.2. Safe harbour or other prescriptive rules can be an attractive option for developing countries with limited access to resources and data (e.g. comparables), mainly because they can provide ease of administration and predictability of the transfer pricing regime using simplified rules to establish transfer pricing outcomes. There would be cases where information sourced from tax returns of taxpayers can support the design of safe harbour rules, without breaching confidentiality if it becomes available publicly in aggregated format. Supporters of these types of rules point to the advantages of streamlining compliance, focusing compliance efforts and providing certainty for taxpayers, as well as administrative simplicity for tax authorities.

C.1.2.2.3. It is often stated that safe harbours allow tax administrations (especially when they are just beginning to administer transfer pricing laws) to focus their limited resources, including audit resources, on the more complex and higher risk cases. Given the difficulties of information availability, collection and analysis, many developing countries might consider that at least for SMEs or less complicated transactions, safe harbour rules can contribute to minimizing the complexity and burden of establishing transfer prices. The complexity and burden of this might be disproportionate to the size of the taxpayer or its level of controlled transactions that are subject to the transfer pricing rules.⁹

C.1.2.2.4 Notwithstanding the notions reflected in the paragraphs above, when considering the introduction of safe harbours, it is necessary to analyse the pros and cons of said measure; e.g. contrasting the benefits in terms of costs of administration versus forecasted levels of tax collection, as well as the trade-off and impact of the measure on parameters such as foreign direct investment, etc.

C.1.2.2.5. Safe harbour rules may also be useful in relieving SMEs of compliance burdens that disproportionately affect them as compared to larger MNE groups (and may affect their ability to compete). In the case of large MNE groups, such rules may also relieve similar compliance burdens in relation to small or less risky transactions (e.g. transactions with no unique and valuable intangibles or significant risks). For example, safe harbours can decrease the compliance burden to some extent by their application to a certain class of transactions within a certain defined threshold, such as low value-adding services and

9 OECD Transfer Pricing Guidelines, paragraphs 4.95 to 4.100.

interest rates in respect of short-term inter-company “plain vanilla” (i.e. on standard terms) loans of moderate value.

C.1.2.2.6 There are at least three concepts that the safe harbour rules may prescribe: the category of transactions eligible, the transfer pricing method and the corresponding range or result to be used. In this context, even though the first two concepts may be introduced by regulation, administrations may publish the applicable range or result in administrative regulations, to maintain the benchmark updated periodically.

C.1.2.2.7. There are possible downsides to safe harbours and other prescriptive rules, including the possibility of abuse or that the rules diverge from arm’s length outcomes. An example of such abuse is breaking down what is in reality a large transaction into several smaller ones to remain within the safe harbour threshold. There is also a risk that taxpayers’ lobbying efforts would make it difficult to remove safe harbours when capabilities have improved and they are no longer needed, or when conditions have changed so that they are no longer appropriate. There is also the possible risk that safe harbour rules are too generous; this can possibly result in revenue unnecessarily foregone. This will also be the case if transactions that would otherwise have been concluded at market prices are priced at the limit of the safe harbour. Or there may be a distortionary impact in that such a regime may encourage and perpetuate an economy based on small-scale or low-profit transactions rather than higher-risk/higher-reward transactions (e.g. technology based) to which the safe harbours will not apply. Safe harbours may thus even discourage investment in high-margin activity as compared to low-margin activities.

C.1.2.2.8. The section on safe harbours in Chapter IV of the OECD Transfer Pricing Guidelines discusses some potential disadvantages of safe harbour rules, such as the reporting of taxable income that is not in accordance with the arm’s length principle, increased risk of double taxation or double non-taxation when adopted unilaterally, potential for creating inappropriate tax planning opportunities, and equity and uniformity issues due to the creation of two sets of rules in the transfer pricing area. In conclusion, where safe harbours can be negotiated on a bilateral or multilateral basis, they may provide significant relief from compliance burdens and administrative complexity without creating problems of double taxation or double non-taxation, which also can be reached by unilateral safe harbours rules when they fall within the scope of double tax treaties (e.g. allowing access to MAP). It is also stated that tax administrations should carefully weigh the benefits of and concerns regarding safe harbours, making use of such provisions where they deem it appropriate.¹⁰

C.1.2.2.9 Notwithstanding that safe harbours may present certain disadvantages as previously mentioned, it is worth mentioning that in the context of small taxpayers or less complex transactions, said disadvantages might be surpassed by the benefits of such provisions. Provided that the safe harbour is elective, taxpayers may consider that a moderate level of double taxation, if any arises due to the safe harbour, is acceptable in terms of relief when contrasted with the necessity of complying with complex transfer pricing rules. It can be argued that taxpayers are able of making the decision of electing the safe harbour as to whether the possible double taxation is acceptable or not.

C.1.2.2.10 When designing safe harbours, it is important to consider allowing for flexibility to “opt-in” or “opt-out” of said measure. Opt-in refers to a safe harbour in which the taxpayer can choose to “opt-in” in order to benefit from it. In this scenario, a taxpayer that chooses not to opt-in must apply the transfer pricing rules and document their application. An “opt-out” safe-harbour requires the taxpayer to apply the method specified to the transactions within scope of said measure, unless it opts not to. If a taxpayer opts out, it must apply the transfer pricing rules and document their application, meaning that it bears the burden of

¹⁰ OECD, Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines, available at: <http://www.oecd.org/ctp/transfer-pricing/Revised-Section-E-Safe-Harbours-TP-Guidelines.pdf>.

proof that its controlled transactions were conducted in line with the arm's length principle. An "opt-out" regime will thus be a more straightforward option for many developing countries as it has the potential to reduce administrative costs.

C.1.2.3. Safe Harbour Practical Issues

C.1.2.3.1. In general, safe harbour rules tend to provide an option that exonerates taxpayers from complying with general transfer pricing rules and facilitate tax compliance. In this regard, if the transactions stay within the safe harbour limits, there may be no need to apply transfer pricing methods and/or maintain contemporaneous documentation mandated in the transfer pricing legislation.

C.1.2.3.2 The Organisation for Economic Cooperation and Development (*OECD*) has proposed a simplified approach in the form of fixed margin (5% mark-up on costs) in dealing with low value-adding services (*LVAS*)¹¹. The OECD defines *LVAS* as services of a supportive nature, not forming part of the core business of the enterprise, and that does not use any intangibles or assume significant risks.

C.1.2.3.3 In addition, the Platform for Cooperation on Tax (*PCT*)'s toolkit for *Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses*¹² includes a comparative analysis of the country practices in determining safe harbours to be applicable to *LVAS* (i.e. containing information on (i) definition of *LVAS*, (ii) excluded transactions and (iii) margin or mark-up for said safe harbour).

C.1.2.3.4. Some of the most common requirements to apply for a safe harbour regime are listed below:

- The benefits are aimed at taxpayers engaged in certain strategic activities of the country in which the taxpayer is located.
- The regime is restrained to certain conditions or thresholds such as the amount of the transaction, revenue proportion ratios, profit earned over intercompany transactions, average sales prices ratio, location among other indicators or ratios set by the transfer pricing regulations.
- Statutory margins are established by law and are available for certain transactions.
- To be eligible it is important that the related party is not resident in a low tax jurisdiction.

C.1.2.3.5. For all other transactions exceeding the safe harbour limits, taxpayers could be required to with all transfer pricing rules and the burden of proof remains with the taxpayer.

C.1.2.3.6. Another aspect arising from some safe harbour experiences in the world is that when fixed margins are established they could be perceived as being too high. The corresponding country may not accept such fixed margins as arm's length result. In these cases, there is a significant risk of double taxation, as the corresponding country may not be keen on making a corresponding adjustment if the taxpayer cannot prove that the statutory margin established by the safe harbour regime is at arm's length.

C.1.2.3.7. Although there are some exceptions, according to the tax rulings of each country as well as tax treaties, the safe harbour regime may include provisions and regulations of the procedure for applying for

11 OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/9789264241244-en>. Further, it was incorporated in Chapter VII of the 2017 Transfer Pricing Guidelines.

12 Platform for Collaboration on Tax (PCT) (2017), "Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses", <https://www.oecd.org/ctp/toolkit-on-comparability-and-mineral-pricing.pdf>

a MAP. The time depicted in the process and the success of the claim will depend on the treaty partner and the type of transactions under request.

C.1.2.3.8. As an option for the safe harbour, tax authorities may also allow taxpayers to apply for an Advance Pricing Agreement (APA) to comply with the transfer pricing regime.

C.1.2.5. Downwards Adjustments

C.1.2.5.1. Since implementation of transfer pricing rules usually result into adjustments that increase the amount of tax payable, a taxpayer may seek, on examination, a reduction in a transfer pricing adjustment and in taxable income, arising from unintentional over-reporting of taxable income. However, no clear guidance in this regard is found in the OECD Transfer Pricing Guidelines. The only guidance available indicates that tax administrations may or may not grant the request for downward adjustment at their own discretion.¹³ It adds that tax administrations may also consider such requests in the context of MAPs and corresponding adjustments. This is an issue which developing countries should also consider when designing their domestic legal environment for transfer pricing.

C.1.2.5.2. The Republic of Korea's experience may be considered as an example in this regard. In 2010, the Republic of Korea clarified in its tax law that a downward adjustment should be applied in cases where a tax adjustment is made under a transfer pricing method using multiple year data. Therefore, tax officials are no longer given any discretion to make the adjustment only for years with a deficient profit, and to disregard years with excess profits, when they adjust the taxpayer's profit level under a transfer pricing method using multiple year data.

C.1.2.5.3. In South Africa, the legislative provision that requires that terms and conditions should be adjusted to those that would have existed had the parties been independent persons dealing at arm's length, is limited to situations where the taxpayer will always make adjustments that favour them, but may be much less likely to do so for adjustments that do not. The over-reporting of taxable income would not fall within the meaning of a tax benefit.

C.1.2.5.4. The Mexican tax administration issued rules for the application by taxpayers of transfer pricing adjustments. The aforementioned rules (i) define the notion and types of "transfer pricing adjustments", (ii) timing of application, (iii) indicate the information that has to be compiled by taxpayers regarding said adjustments; (iv) explain the effects that may arise with regards to line items related to withholding and (v) address consequences of the adjustments on indirect taxes (VAT).

C.1.2.6. Advance Pricing Agreements/Arrangements

C.1.2.6.1. APAs have been introduced in many countries to confirm the arm's length result generally in advance by agreement between taxpayers and tax authorities on certain sets of criteria (transfer pricing methods, comparables and appropriate adjustment thereto, critical assumptions as to future events etc.). To a great extent, APAs have reduced transfer pricing adjustment risks for multinationals, especially under bilateral or multilateral APAs involving two or more countries, and therefore the number of applications for APAs has reached almost the number of adjustment cases in some developed countries.¹⁴ On the other hand, although unilateral APAs are categorized as partial solutions for double taxation, they are also

¹³ OECD Transfer Pricing Guidelines, paragraph 3.17.

¹⁴ From 1 July 2015 to 30 June 2016, Japan received 149 applications for APAs, whereas it adjusted 240 cases after examination for the same period.

considered useful in specific cases depending on all the facts and circumstances. The OECD Transfer Pricing Guidelines strongly endorse APAs as a supplement to the traditional administrative, judicial and treaty mechanisms for resolving transfer pricing issues.¹⁵

C.1.2.6.2. When implementing APAs, tax administrations have to bear it in mind that the APA process is, in practice, a service to taxpayers. Consequently, appropriate capacity must be installed in the tax administration in order to adequately respond to taxpayers' demand in terms of response time, volume of requests, complexity of cases, etc. In addition, within a legislative design context, taxpayers may be required to pay fees when filing an APA request to cover the actual costs of processing APA requests.

C.1.2.6.3. One of the key advantages of adopting an APA system is that uncertainty can be diminished through enhancement of predictability of the taxation of international transactions. Developing countries thus have a good opportunity to obtain access to the existing documentation which is relevant to their covered/analysed operations. A second advantage is that APAs can provide an opportunity for both tax administrations and taxpayers to consult and cooperate in a transparent and non-adversarial spirit and environment. As a third advantage an APA may prevent costly and time-consuming examinations and litigation of major transfer pricing issues for taxpayers and tax administrations.

Fourthly, the disclosure and information aspects of an APA programme as well as the cooperative attitude under which an APA can be negotiated may assist tax administrations in gaining insight into complex international transactions undertaken by MNEs.¹⁶

C.1.2.6.4. Some consider adequate levels of experience to be necessary before the appropriate type of APA can be achieved, while others see the experience gained in concluding APAs as an important part of capacity-building on transfer pricing issues. Matching operational capability to offer APAs with operational capability of the transfer pricing regime is thus an important factor in the design of the domestic legal environment.

C.1.2.6.5. Some countries choose not to have APAs, at least for some time after their transfer pricing regime is put in place. For example, they may feel that they need to develop capacity and skills before they can properly evaluate what is an appropriate APA system for them.¹⁷ Other countries are concerned that APAs are not useful in a transfer pricing regime because they tend to be sought by companies that are in broad conformity with the arm's length principle and may divert scarce resources from achieving compliance in the worst cases of avoidance. As with any such mechanism, checks and balances must be provided to ensure that the APA process is applied consistently between taxpayers and is not subject to abuse or integrity issues. The advantages and disadvantages of APAs are discussed in more detail in Chapter C.4. on Dispute Resolution and Avoidance: it may, however, be noted that consideration must be given to the inclusion of an APA programme at different stages of the design of a legal framework for transfer pricing.

C.1.2.7. Interaction of Transfer Pricing Provisions with Other Cross-border Rules

C.1.2.7.1. In designing a domestic tax system, consideration must be given to the interaction of transfer pricing rules with Controlled Foreign Corporation (CFC) rules. CFC rules are designed to prevent tax being

¹⁵ OECD Transfer Pricing Guidelines, paragraphs 4.123 to 4.165. In addition, see the Annex to Chapter 6 on "Guidelines for conducting APA under the MAP".

¹⁶ OECD Transfer Pricing Guidelines, paragraph F.3 Advantages of advance pricing arrangements.

¹⁷ After almost a decade of experience of implementation of transfer pricing regulations in the country, India introduced APAs with effect from 1 July 2012 in the Income Tax Act. Financial Year 2013-14 was the first year that APAs came into effect. Since then India has signed more than 100 unilateral and bilateral APAs.

deferred or avoided by taxpayers using foreign corporations in which they hold a controlling shareholding in low-tax jurisdictions. Without CFC rules income could be left in low tax jurisdictions and remain outside the scope of domestic tax rules. CFC rules treat this income as though it has been repatriated and it is therefore taxable on the resident shareholders. It is widely considered that the transfer pricing rules should have priority and the CFC rules should apply to the profits remaining in controlled foreign companies after application of the arm's length principle (see section B.1.7.7.).

C.1.2.7.2. It may sometimes be more advantageous for tax purposes to finance a company by way of debt than of equity as the interest paid on debt may be deducted for tax purposes while dividends on equity may not be tax deductible. In many countries thin capitalization provisions have been introduced to deny a deduction for excessive interest payments. This is done by prescribing a maximum debt-to-equity ratio or (net) interest to EBITDA and disallowing a proportion of interest payments if debt exceeds this maximum level (see section B.1.7.8.). These rules protect the tax base by discouraging cross-border shifting of profits through excessive interest payments on debt.

C.1.2.7.3. Some countries that do not have very detailed transfer pricing rules in place may deal with abusive forms of transfer pricing through the use of a general anti-avoidance rule (GAAR). Abusive non-arm's length transactions may come within the scope of the GAAR. This may be useful in the early stages of introducing a transfer pricing regime, however use of the GAAR in transfer pricing issues may create uncertainty for business which may therefore prefer detailed transfer pricing legislation, regulations or guidance.

C.1.2.7.4. In accordance with the mandate of Action 14 of the BEPS Project, the countries worked to "develop solutions to combat the obstacles that prevent countries from resolving disputes related to agreements through mutual agreement procedures (MAP), including the absence of provisions on arbitration in the majority of countries' agreements and the fact that access to mutual agreement procedures and arbitration may be denied in some cases."

C.1.2.7.5. The measures agreed upon under this action sought to strengthen the effectiveness and efficiency of this procedure by minimizing the risks of uncertainty and unintentional double taxation by ensuring consistent and appropriate implementation of tax treaties.

C.1.2.7.6. As a result of the final report of this action, a significant number of countries agreed to important changes in their position on dispute resolution regarding tax treaties and the commitment of countries in this regard represents a minimum standard. Through said minimum standard it will be ensured that:

- The obligations of the fiscal treaties related to the MAP are fully implemented, in good faith, and that MAP cases are resolved in a timely manner (in an average of 24 months).
- Administrative processes that promote the prevention and timely resolution of controversies on tax treaties, such as guides for taxpayers about the requirements to access the MAP, are implemented.
- Taxpayers will have access to the MAP when they are eligible.

C.1.2.7.7. Being a minimum standard of the Inclusive Framework, there is currently a monitoring of the implementation of this commitment by countries, which seeks to ensure that all countries that are part of the project comply with this standard.

C.1.2.7.8. Through the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Multilateral Instrument) developed pursuant to Action 15 of the BEPS Project, compliance with said standard will be facilitated minimum since it will allow the countries that sign it to incorporate into their existing treaties, among other measures, those derived from Action 14 of

the BEPS Project, which imply modifications to the Article on Mutual Agreement Procedure. In other words, this Multilateral Instrument will make it possible to modify the existing agreements of the countries, avoiding a large number of bilateral negotiations and the burden that the procedures for signing and ratifying implies.

C.1.2.7.9. Within the context of arbitration, one of the main challenges in the framework of Action 14 was the question of mandatory arbitration as a means to ensure the resolution of disputes. This mechanism gives legal certainty to taxpayers about the resolution of a case in which they consider that a measure not conforming to the agreement was applied. Likewise, it encourages the competent authorities not to postpone the discussion of the case, in order to avoid this type of arbitration. Notwithstanding the foregoing, most of the countries participating in the BEPS Project have not chosen to include this alternative, with some of the main reasons that these countries have argued on account of sovereignty issues (i.e. not being able to accept that an arbitration panel decides on issues of domestic taxation), inexperience, distrust of the impartiality of the arbitrators, costs, and possible difficulties in finding specialists who can be appointed as arbitrators. It should be noted that the arbitration can be adopted through the Multilateral Instrument as an option and grants great flexibility with respect to the cases that may be subject to arbitration by allowing countries a reserve mechanism to exclude certain cases from the application of the same.

C.1.3. Keeping Transfer Pricing Regimes Updated

C.1.3.1. Gathering Information

C.1.3.1.1. This section provides information to developing countries about resources available to follow the latest developments in international tax rules and initiatives. It also provides guidance on the mechanisms available for developing countries to obtain training, information updates and to engage in international tax dialogue after it has implemented transfer pricing rules. Such resources will assist countries to keep abreast of developments, exchange peer experiences and keep their transfer pricing regimes updated.

Regional coordination through the existing intergovernmental agencies

C.1.3.1.2. One of the suggested approaches to keep up to date with developments in international transfer pricing legislation is to engage with regional intergovernmental agencies such as Cercle de Reflexion et d'Echange des Dirigeants des Administrations Fiscales (CREDAF), IntraEuropean Organisations of Tax Administrations (IOTA), Inter-American Center of Tax Administrations (CIAT), the African Tax Administration Forum (ATAF), Study Group on Asian Tax Administration and Research (SGATAR), and the Commonwealth Association of Tax Administrators (CATA).

C.1.3.1.3. These are non-profit international public organizations that ~~can~~ may be able to provide specialized technical assistance for the modernization and strengthening of tax administrations in different regions of the world, through conferences, targeted field missions, exchange of information, and sometimes even targeted training. As their names indicate, they tend to cater for a specific geographic region, or a particular group of countries grouped through similar characteristics. Some countries are members to more than one regional organization:¹⁸

18 For example, Australia is a member of both SGATAR and CATA.

- CIAT's predominant membership is from the Americas,¹⁹
- ATAF's membership is primarily of African countries,
- SGATAR's membership is located in the Asia-Pacific region and is currently composed of 17 member tax administrations, and
- CATA's membership currently includes 46 Commonwealth countries spread over all geographic regions of the world.

Engage with institutional stakeholders

C.1.3.1.4. The United Nations, OECD, World Bank and the IMF are all agencies which consistently engage with countries and provide ~~ing~~ capacity development. Countries generally need to apply to those agencies, seeking training which may be specific to the requesting country, or may be provided regionally, as part of a larger group of tax administrators. Following the work of the United Nations and the OECD is key to keeping domestic transfer pricing regimes updated. Engaging in international tax dialogues is also a means to obtaining updated information with respect to the latest developments in transfer pricing.

C.1.3.1.5. Some national and regional tax administrations also provide very good guidance in the field of international taxation in general, and transfer pricing specifically, in areas where they themselves face difficulties in compliance and policy formulation. The United Kingdom's HMRC, South Africa's SARS, the Brazilian Receita Federal, the United States' IRS, and the European Commission (within the European Union) are all very sophisticated bodies which provide guidance on policy and on their own interpretation of certain international tax provisions.²⁰ These national tax administrations, regional organizations and others could be followed and even consulted by developing nations wishing to resolve perhaps similar problems arising as a result of the application of their own transfer pricing rules.

C.1.3.1.6. Finally, some academic institutions, research centres and think tanks have funds to invest in capacity development in developing countries, and encourage their experts to provide such assistance.

Create a clearing house for information and capacity development with like-minded countries

C.1.3.1.7. Like-minded tax administrations should come together to share experiences and tax information which they consider useful for other tax administrations. That is particularly relevant for countries that share borders, have similar legal backgrounds or may be part of a regional economic group.

C.1.3.1.8. By acting within an organized group, tax administrations can share training expenses while promoting capacity development, disseminate knowledge, organize joint seminars, share the contents of training received from intergovernmental institutions such as the IMF, OECD, PCT the UN and the World Bank, and also bid for capacity development funding from donor agencies, foundations and agencies. The various international organizations have issued a number of toolkits for tax administrations in developing countries, which should be an important resource in capacity development.

19 There is a special category of associate member. CIAT's General Assembly may accept as Associate Members countries from regions other than the Americas that apply for accession and have the approval of the Executive Council. There are currently 5 European countries, 2 African countries and 1 Asian country in CIAT's membership.

20 Some of them are not available in English.

Participate in the South-South dialogue for capacity development

C.1.3.1.9. In general, tax authorities in developing countries lack sufficient qualified and experienced personnel to understand the concerns of MNEs and to deal with controversial transfer pricing issues, especially in view of global developments around new, rapidly developing topics such as BEPS. Regular training, foreign language skills, information exchange and experience sharing is necessary for capacity development. A knowledge sharing platform with other tax authorities (a regional institution, or a clearing house institution) could be an important step in this regard. International secondments to gain more experience at the United Nations, the OECD or in another tax administration should be considered if possible. An independent external consultancy body might also be an option, as explained below. Other capacity development issues are covered in detail in Chapter C.5.

C.1.3.1.10. A higher risk of unnecessary miscommunications between taxpayers and revenue authorities on some less important points is one of the main challenges in countries where transfer pricing regulations are relatively new. A greater pool of transfer pricing experts would be helpful to revenue authorities and taxpayers who are trying to address complex transfer pricing issues in such countries. These experts could assist, e.g. revenue authorities and taxpayers in advanced dispute resolution processes to provide expert perspectives. This could be a short-term solution to help to reduce the number of protracted enquiries where taxpayers have tried to apply approaches that are consistent with international principles.

C.1.3.1.11. A pool of experts might be found from engagement with regional intergovernmental organizations, neighbouring countries, countries sharing the same language or from active participation in a South-South dialogue.

C.1.3.2. Updating National Tax Legislation

C.1.3.2.1. This section seeks to provide advice on the instruments that exist for tax administrations to introduce unilateral policies that draw upon the current international discussions, without having to go through the whole legislative process in modifying tax legislation that might at times be controversial or suit purposes other than transfer pricing.

Tax rulings

C.1.3.2.2. Tax rulings work very similarly to APAs. One of the differences between them is that a tax ruling can be granted on any tax issue, and an APA relates only to the application of transfer pricing regulations. Another difference is that a tax ruling is unilaterally signed by the tax authority, and an APA can be signed by both parties. As under the APA, tax rulings tend to grant greater legal certainty to the tax system by establishing, a priori, a tax rate, or a modified tax base, or by recognizing a taxpayer's unique circumstances. A ruling may also be used to attract foreign direct investment, assuming that the tax administration uses the tax ruling to bring certainty or even grant more favourable tax treatment to a specific taxpayer.

C.1.3.2.3. Tax rulings also help create an active tax dialogue between taxpayer and tax administration and stimulate greater cooperation to the extent both parties fix an understanding to pay or not to pay certain taxes. Since tax rulings are tailored towards a specific taxpayer or group of taxpayers, they can also have the effect of modifying the domestic tax legislation of a country through a "special proceeding", suitable only for a particular situation or taxpayer, without having to modify the entire legal tax system of a country. To that extent, and because the legislative process runs a lot more slowly than the conferral of an administrative decision, it might be helpful in allowing countries to follow the trends set in the international

scene. A country wishing to grant tax rulings needs to have the legal basis for it in its domestic tax legislation

C.1.3.2.4. In accordance with the minimum standard, Action 5 of the BEPS Report also establishes a commitment to transparency through the compulsory spontaneous exchange of relevant information on taxpayer-specific rulings.

Establish an international consultancy body

C.1.3.2.4. Developing countries might benefit from establishing an independent organization (an expert body, composed of academics, industry experts, and/or government officials) to advise them on the ways through which they might be able to fine tune or update their legislation. An independent advisory group could suggest updates, point out controversial issues in the country's legislation, suggest action in certain transfer pricing areas, and even audit the country's tax legislation for improvement.

C.1.3.2.5. Developing countries should, through participation in regional and global dialogues, be able to benefit from the use of existing consultancy bodies used by countries with similar legislation, or countries located within the same geographic region. This should help manage costs if countries opt to be evaluated contemporaneously with each other. The effort could be hosted in an existing cooperation organization, as mentioned above, or within a UN specialized organization to further manage costs. Regional organizations, such as ATAF, are known to have also provided similar capacity for their member countries.

* * *

[NOTE: THIS SECTION IS INSERTED HERE TEMPORARILY – PENDING FURTHER CONSIDERATION IN THE LIGHT OF DISCUSSION OF SECTION D6.]

C.1.2.7. Dispute resolution

C.1.2.7.4. In accordance with the mandate of Action 14 of the BEPS Project, the countries worked to "develop solutions to combat the obstacles that prevent countries from resolving disputes related to agreements through agreement procedures, including the absence of provisions on arbitration in the majority of countries' agreements and the fact that access to agreement procedures and arbitration may be denied in some cases."

C.1.2.7.5. The measures agreed upon under this action sought to strengthen the effectiveness and efficiency of this procedure by minimizing the risks of uncertainty and unintentional double taxation by ensuring consistent and appropriate implementation of tax treaties.

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C.1.2.7.9. Within the context of arbitration, one of the main challenges in the framework of Action 14 was the question of compulsory arbitration as a means to ensure the resolution of MAP cases. This mechanism gives legal certainty to taxpayers about the resolution of a case in which they consider that a measure not conforming to the agreement was applied. Likewise, it encourages the competent authorities not to postpone the discussion of the case, in order to avoid this type of arbitration. Notwithstanding the foregoing, most of the countries participating in the BEPS Project have not chosen to include this alternative, with some of the main reasons that these countries have argued account for sovereignty issues (i.e. not being able to accept that an arbitration panel decides on issues of domestic taxation), inexperience, distrust of the impartiality of the arbitrators, costs, and possible difficulties in finding specialists who can

be appointed as arbitrators. It should be noted that the arbitration can be adopted through the Multilateral Instrument as an option and grants great flexibility with respect to the cases that may be subject to arbitration by allowing countries a reserve mechanism to exclude certain cases from the application of the same.

C.1.2.8. Tax Intermediaries / Mediation

C.1.2.8.1. Developing countries may consider the introduction of an effective domestic dispute resolution mechanism that can minimise disputes by resolving controversies at the earliest point in time, as this is most cost effective for both the taxpayer and the tax authority.

C.1.2.8.2. Administrations can consider a statutory dispute settlement process independent and parallel to the audit and examination functions, which could be accessed through a request by the taxpayer. In Mexico, this kind of domestic supplementary dispute mechanism has been successful in solving transfer pricing controversies that arise during tax audits, therefore minimising the need to pursue appeals or litigation to solve the dispute.

C.1.2.8.3. Even though double taxation can often be a concern of such settlements, since they may preclude competent authorities from negotiating a different result in a bilateral MAP, and the foreign tax authority may not agree to partial or total relief of the tax, these dispute resolution alternatives should not necessarily be an obstacle for taxpayers to seek a correlative adjustment with the competent tax authority of their respective jurisdiction.

C.1.2.8.4. Further reflections and the need for guidance arise with respect to the circumstances under which a Contracting State could accept the agreed solution in a domestic dispute settlement process of the other Contracting State. This guidance may be in the form of a (i) safe harbour or (ii) under a reciprocity treatment between the States involved.

ATTACHMENT F: PRACTICAL IMPLEMENTATION OF A TRANSFER PRICING REGIME - CAPABILITY

[General Note: The only change in substance since consideration at the 18th Session of the Committee is the inclusion, as anticipated, of some Kenyan experience at Para. 82 [C.5.9.3.4] and following (p.34).]

[Note: Section C.1.1.4, comprising C.1.1.4.1 – C.1.1.4.8 will be deleted in its entirety because its substance duplicates material now found in new section C.2., below. A more detailed revision of C.1 is at Attachment E to this paper.]

ESTABLISHING TRANSFER PRICING CAPABILITY IN DEVELOPING COUNTRIES.

[Note: this Section, previously C.5., is proposed to be moved to become Section C2. In the updated Manual. Existing section c.2. (documentation) would be renumbered as Section C.3. The text of new Section C.3. (previously C.2.) Has not been modified in any way as part of this revision of Section C. Paragraphs will be renumbered accordingly.]

C.2.1. Introduction

1. [C.5.1.1.] This Chapter addresses issues involved in setting up a dedicated transfer pricing unit in the tax administration to administer the country's transfer pricing rules. There are important opportunities as well as challenges in setting up such a unit for the first time. The design of such a unit, its vision and mission statements and the measurement of whether it has been successful will have to take into account factors such as:

- The relationship between the tax policy function and the tax administration function;
- The need to evaluate current capabilities and gaps to be filled;
- The need for a clear vision, a mission and a culture that will facilitate effective administration of the law;
- Organizational structure;
- Approaches taken to building team capability;
- The need for effective and efficient business processes;
- The advantages of staged approaches to reaching long-term goals; and
- The need for monitoring to assess effectiveness and for ongoing fine tuning of the organizational structure and administrative processes.

2. [C.5.1.2.] These points provide a useful framework when setting up a transfer pricing unit. There is no perfect "template" that will be suitable for all countries in every respect. These issues will all need consideration in the context of the country's overall tax administration and legal structures.

C.2.2. Relationship between Tax Policy and Tax Administration

3. [C.5.2.1.] In most countries, the tax policymaking function generally resides with the Ministry of Finance rather than with the tax administration. The other revenue generating organs of government (e.g. the customs service)⁸⁶ are also usually separate from the tax administration. There is, however, a particular need to bridge the gap between the policymaking function and the tax administration in order to implement an effective transfer pricing regime. This need arises due to:

- The complexity and resource intensiveness of administering a transfer pricing regime;
- The potential costs of compliance for taxpayers and of collection by tax administrations;
- The large amounts of money that may be at stake; and
- The international dimension given the link to binding tax treaties through provisions based upon Article 9 of the UN and OECD Model Conventions, issues of potential double taxation, and the interest of other countries.

4. [C.5.2.2.] The respective responsibilities and functions of the tax administration and of the policymaking function should be clear. Mechanisms for contact and coordination between the two should be well understood. Duplication and overlap of functions should be avoided, and processes for coordination between the two should be streamlined.

5. [C.5.2.3.] Some factors that could improve cooperation include:

- Recognition of the need to have a “policy feedback loop” so that the policy reasons for a transfer pricing regime are properly reflected in that regime and in its administration, and so that practical lessons from the administration of the tax administration can provide feedback in order to fine tune policy. Examples are:
 - Where aspects of the policy are expensive or otherwise very resource intensive to administer, and the likely revenue return is not commensurate with these costs;
 - Where a wider treaty framework and strong exchange of information provisions would be beneficial; or where there is a need to ensure that the framework of thresholds, deterrence mechanisms, and penalties is effective and up to date; and
 - Where the experience of the administration and competent authorities in taxpayer service, education, enforcement, and case resolution can aid in improving legislation or implementing regulations;
- Cross-secondment of tax administrators and policymakers to each other’s teams can help ensure that administration officials understand the policymaking process and the objectives of the legislation, and that policymakers understand the practical issues of tax administration. Good tax policy must be able to be administered and good administration must have sound policy underpinnings;
- Involvement of the tax administration in developing investment policies, including involvement in discussions about tax incentive and tax holiday policies that may affect transfer pricing and other aspects of tax administration; and

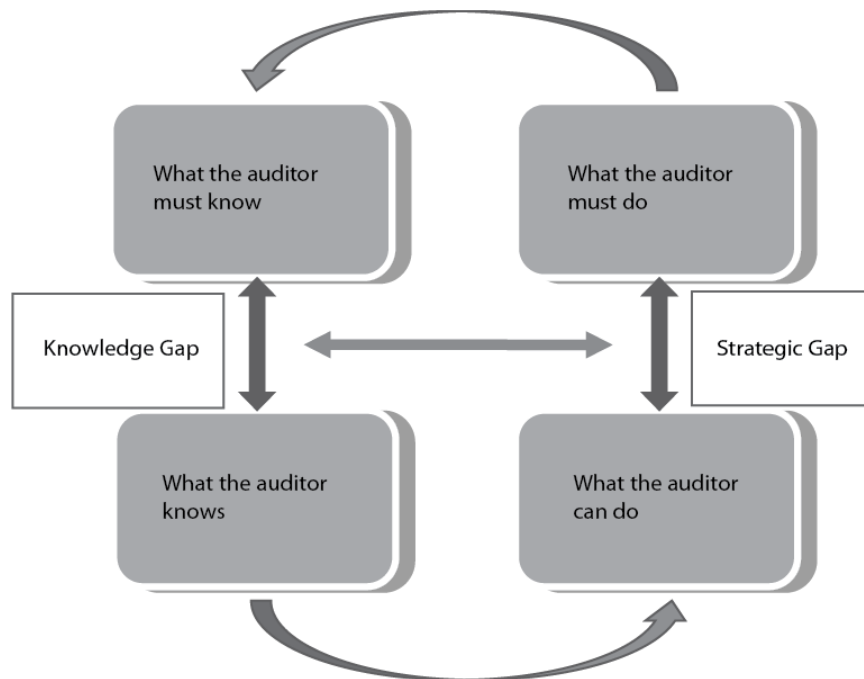
⁸⁶ Customs are relevant for transfer pricing in relation to issues of valuation. See for example the discussion at Chapter B.2., paragraph B.2.4.7. of this Manual and World Customs Organization, *WCO Guide to Customs Valuation and Transfer Pricing* (2015); available at: <http://www.wcoomd.org/en/topics/key-issues/revenuepackage/~media/36DE1A4DC54B47109514FFCD0AAE6B0A.ashx>.

C.2.3. Assessing Current Capabilities and Gaps to be Filled

6. [C.5.3.1.] Different tax administrations require different types of administrative arrangements when it comes to implementing their government’s transfer pricing policies. The level of development/capability in the tax administration should be a key factor to consider when formulating policies. In many cases, there is an unrealistic expectation that increases in capability across too many areas can be achieved in a short time. Skill in administering transfer pricing rules can only be developed by practical experience in addressing actual transfer pricing cases.

7. [C.5.3.2.] In addressing the issue of building transfer pricing capability it is important to realistically evaluate the actual level of existing knowledge and the best organizational approach. The focus in this Manual is on countries with little or no existing experience in transfer pricing, so there are initial start-up issues. There is also a recognition that not everything can be achieved at once and that the system and the administrative capability will need to evolve over time through practical experience and as part of a capacity building plan. This is sometimes termed a “life cycle approach”. A possible approach is outlined below in Figure C.5.1.⁸⁷

Figure C.2.1:
Audit Process



8. [C.5.3.3]. Factors to consider when assessing the level of development/capability of the tax administration:

- Levels of education and expertise of personnel involved with administration of transfer pricing rules;

⁸⁷ Michael Zack, “Developing a knowledge strategy: epilogue”, in *The Strategic Management of Intellectual Capital and Organizational Knowledge*, Nick Bontis and Chun Wei Choo, eds. (Oxford, Oxford University Press, 2002).

- The legal environment or framework (as addressed in Chapter C.1.) including the characteristics of the transfer pricing legislation and responsibilities for and the scope of regulations. A clear and transparent legal framework is important to the functioning of the administration as a whole;⁸⁸
- Whether or not a network of comprehensive bilateral tax treaties exists, including articles relating to Associated Enterprises (usually Article 9), the Mutual Agreement Procedure (usually Article 25) and Exchange of Information (usually Article 26). Additionally, the existence of any more limited exchange of information agreements should be evaluated—especially with the countries of residence of key participants in the economy and their related parties;
- Availability of necessary economic and financial information within the country/tax administration; and
- Availability of information technology systems that allow for the most effective strategies to encourage compliance, develop and support audit strategies and facilitate collection and litigation where necessary, as well as those skilled in using them.

C.2.4. Developing the Mission, the Vision and the Culture of the Unit

C.2.4.1. Objectives

9. [C.5.4.1.1.] The objectives of the transfer pricing team should be clear, both to team members and to others that they are engaging with. This includes others in the administration, those involved in the tax policy function, and stakeholders such as taxpayers and their advisors. Often this is put in terms of developing a “mission statement” reflecting what the transfer pricing unit will do in its daily operations and a “vision” representing what an ideal future will look like when the unit carries out its mission properly. Many tax administrations also have a “Taxpayer’s Charter” which reflects what taxpayers can expect from the administration, and what is expected from taxpayers in their relationship with the transfer pricing administration.

10. [C.5.4.1.2.] Documents reflecting the mission and the vision should become part of the culture and be “lived out” by the unit on a daily basis rather than merely being framed and put on the wall. This will be assisted by, for example, developing a team charter aligned with the wider organizational charter agreed by senior managers in the transfer pricing unit and key persons in the tax administration as a whole, preferably after conversations with stakeholders. This could usefully draw upon the experience of other countries though it must be tailored to each country’s own realities. It is of course necessary to keep under review whether the mission and vision are being achieved in practice and, if not, why they are not being achieved.

11. [C.5.4.1.3.] An important part of defining the unit’s objectives involves identifying and recognizing the limitations on available resources. Clearly determining what is inside and outside the competence of the unit will help clarify what resources are needed to meet the objectives of the unit and encourage the best use of such resources.

⁸⁸ Katherine Baer, Olivier Benon, Juan Toro, *Improving Large Taxpayers’ Compliance: A Review of Country Experience*, (Volume 215 of *International Monetary Fund*, Occasional paper, 2002). Available at <http://www.imf.org/external/pubs/nft/op/215/>.

C.2.4.2. Client/Taxpayer Orientation

12. [C.5.4.2.1.] A central consideration to be borne in mind is that a transfer pricing unit will have important taxpayer service and education functions as well as a central enforcement function. These functions are interrelated: better education and taxpayer service reduces the cost, resource-intensiveness and “pain” of compliance. This, in turn, helps increase compliance (those wanting to comply find it easier to do so) and allows the administration to focus enforcement measures on the greatest risk areas (in particular, on taxpayers who have no intention of complying with their obligations).

13. [C.5.4.2.2.] Understanding the functions and environment of MNEs will further the tax administration’s service, education, and enforcement activities. Handling their taxation issues will inevitably lead to more contacts between MNEs and the transfer pricing unit. For instance, MNEs have to disclose their documentation and systems, while tax administrations have to be aware of the dangers of unnecessarily high administrative burdens, and therefore compliance costs, for MNEs. High compliance costs are inefficient and may unnecessarily give a negative view of a country’s investment climate, deterring potential investors.

14. [C.5.4.2.3.] On the other hand, increased focus on transfer pricing issues will inevitably lead to some disputes with MNEs and the possibility of double taxation. Another country may regard more of the profits of a transaction between related parties as subject to its tax jurisdiction in accordance with a bilateral treaty, resulting in fewer profits being (in that country’s view) subject to tax in your jurisdiction. This is an increasingly common issue in transfer pricing and tax administrations need to devote sufficient resources to avoid unnecessary differences of opinion. They need to ensure, where possible, that those differences do not lead to unnecessary disputes and they need to deal with formal dispute resolution procedures as expeditiously and effectively as possible when a dispute cannot be avoided.

15. [C.5.4.2.4.] Most double tax treaties contain a Mutual Agreement Procedure (MAP) article that is designed to avoid double taxation, based upon the UN or OECD Model Tax Conventions, as noted in Chapter B.1.; see also Chapter C.4., Section C.4.4. Often this is Article 25 in bilateral treaties, as it is in both Models. However, a MAP conducted between competent authorities can be very resource-intensive and costly for both tax authorities and MNEs. As such, it is especially worthwhile to put sufficient energy and resources into risk assessment and establishing contact points between the tax administration, the competent authorities under tax treaties, and policymakers to avoid unnecessary adjustments in tax assessments.

16. [C.5.4.2.5.] Engagement with taxpayers and their tax advisors is necessary to understand the transfer pricing systems and practices of MNEs, and for the MNEs to understand what is required from them in a newly introduced transfer pricing regime. This will help taxpayers and the tax administration to explore shared interests in clarity, transparency, and certainty, to understand and reduce the risks of aggressive tax positions, to increase awareness of commercial realities, fairness and consistency between taxpayers, and to reduce the costs of compliance and collection.

17. [C.5.4.2.6.] There is a need for considerable early investment in taxpayer education. The tax administration also needs to ensure professional and effective relationships with taxpayers as an element of taxpayer service. This is one area where the experience of other similarly placed administrations is likely to be especially helpful.

18. [C.5.4.2.7.] Overall, there needs to be a sustained commitment to this part of the “set up process”, which is designed to maximize compliance and to assist in risk management (by helping differentiate non-compliance due to lack of understanding from more deliberate and therefore systemically risky non-compliance). A fair amount of institutional patience and sustained commitment is required if the transfer pricing regime is to fully meet its medium- to longer-term goals.

19. [C.5.4.2.8.] Some specific steps through which this can be achieved by tax administrators include:

- Knowing taxpayers and their commercial environment, as well as their main issues and concerns, and having in place a continuous dialogue with taxpayers, tax professionals, their associations or peak representative bodies on tax issues;
- Being reasonable and proportionate in actions, and open and transparent with taxpayers;
- Being responsive to requests;
- Extensive and clear taxpayer education, including making tax guidance notes available to taxpayers, information circulars and other guidance on interpretation of tax laws to avoid misunderstandings, confusion and surprises to those willing to meet their obligations;
- An informative and easy to navigate Internet presence that is regularly tested and kept under review for its user-friendliness and relevance;
- Seeking to avoid disputes arising unnecessarily but also setting up clear and fair systems for addressing such disputes that do not unfairly deter taxpayers from pursuing legitimate grievances; and
- Providing a process for obtaining advance rulings and advance pricing agreements on specific issues of taxpayers.

20. [C.5.4.2.9.] Steps that could be encouraged among taxpayers and their advisors include:

- Being transparent and open about their risks, including by making voluntary disclosures to the tax administration;
- Preparing accurate and complete transfer pricing documentation in accordance with the guidance on documentation in the final BEPS reports and in Section C.3. of this Manual;
- Requesting and obtaining advance rulings before embarking on activities with important tax consequences, or participating in advance pricing agreements where they exist;⁸⁹
- Making their transfer pricing policy available to the tax administration as part of the required documentation;
- Recognizing the resource limitations on the side of the administration and not “playing games” to tie up those resources unnecessarily to the disadvantage of the administration and other taxpayers; and
- Complying with the requirements of the bilateral double taxation treaty between the country they are operating in and their country of residence, and understanding the circumstances when the applicability of the tax treaty to them may be denied.

C.2.4.3. The Enforcement Approach: Risk-Based Approach to Compliance

21. [C.5.4.3.1.] A “risk management” approach to the unit’s work is recommended; this is true for the tax administration as a whole, but particularly when dealing with a new regime involving the complex and resource-intensive issues of transfer pricing. This means having robust processes in place for:

⁸⁹ The issue of whether to institute an APA programme is a complex one, which is addressed in Chapter C.4. of this Manual; see also the relevant discussion at Chapter B.8. Some countries see this as a useful extension of the risk management approach even in the early days of a transfer pricing regime. Others consider that this is more appropriate once there is greater familiarity with and experience of transfer pricing issues, and prefer to focus limited resources in the start-up phase on the most serious instances of non-compliance rather than on taxpayers likely to be in broad compliance.

- Identifying transfer pricing risks;
- Analysing them (including ranking them in terms of their likelihood and their impact if they occur); and
- Determining what can be done to avoid them or to limit their adverse consequences if they cannot be avoided.

The obvious risk is that the right taxpayers do not pay at the right time, but other risks, such as risks to public confidence in the system if taxpayers are not seen as meeting their tax obligations also need to be considered.

22. [C.5.4.3.2.] Issues and procedures related to risk assessment and management are considered in more detail in Chapter **C.4.** of this Manual. In setting up a transfer pricing unit, however, it should be recognized that there is an important role for officers attuned to the organization's approach to risk management and able to implement it systematically for a new area and keep it under review. Consistent risk management strategies will often be developed in conjunction with other areas of the administration, such as those dealing with tax treaties or thin capitalization, or those clustered around relevant industries or in offices that are differentiated based on the size of a taxpayer.

23. [C.5.4.3.3.] As part of this risk management approach, even developed countries with long established transfer pricing regimes and administrations tend in practice to have criteria that define their areas of greatest or least current focus. This often includes thresholds below which they would generally not audit or adjust a controlled transaction for transfer pricing purposes, especially in relation to small and medium-sized enterprises or for transactions below certain values.⁹⁰

24. [C.5.4.3.4.] The criteria referred to above will have to be assessed for each country in the light of its own circumstances, and will have to be kept under review to make sure these criteria are not relied on abusively so that the risk profile has changed.

C.2.5. Organizational Structure for the Transfer Pricing Unit

25. [C.5.5.1.] There are two basic types of structures that can be adopted for establishing transfer pricing capability: a centralized model, with a single transfer pricing unit operating across all industries and geographical areas, or a decentralized model, with separate transfer pricing units by industry or geography. Each has advantages and disadvantages, as follows.

C.2.5.2. Centralized model:

26. Following are advantages and disadvantages of a centralized model:

- *Advantages:* coordination and adjustments to the transfer pricing approach are made easier in the start-up phase; knowledge is built up quickly; the model is in tune with a centralizing tendency in tax administrations (driven in part by the desire for all-encompassing technological developments and compliance strategies); there are clearer lines of authority, communication and reporting within the unit; and communications with other areas tend to be more coordinated.
- *Disadvantages:* there is a risk of being in an “ivory tower”—out of touch with realities on the ground; and a risk that over-centralization may reduce transparency and create opportunities

⁹⁰ See for example OECD, “Multi-country analysis of existing transfer pricing simplification measures”, 10 June 2011, p. 22. Available at <http://www.oecd.org/tax/transfer-pricing/48131481.pdf>.

for mismanagement and corruption. As transfer pricing experts will need, in any case, to work with experts from outside that group, such as people with various auditing skills, and more general tax auditors with some transfer pricing experience, it is at the very least important to guard against such an “ivory tower” mentality (and against being perceived as such) and ensure frequent interactions and exchanges of ideas and even personnel between such groups.

C.2.5.3. Decentralized model:

27. Following are advantages and disadvantages of a decentralized model:

- *Advantages:* there are shorter lines of communication with tax inspectors; an easy diffusion of knowledge; combined industry and transfer pricing knowledge; and the model facilitates a long-term broader dissemination of transfer pricing awareness.
- *Disadvantages:* there are risks that team members will not see their first loyalty as being to the transfer pricing unit but instead to the colleagues they most regularly work with, especially in the start-up phase of a multi-disciplinary, cross-functional team, with the danger of a lack of a single vision and coordination. Such coordination problems may lead to inconsistencies, lack of experience sharing and issues “falling between gaps”; and some taxpayers may take advantage of a lack of coordination by, for example, “picking and choosing” who they approach for rulings.

28. [C.5.5.4.] Whatever model is followed, it is important to have a clear and coordinated approach to transfer pricing issues and their possible solutions, especially as MNEs will generally be far more familiar with transfer pricing issues than individual tax officers in a start-up unit. It is impossible to immediately bring the tax administration to a high level of knowledge in all relevant areas, especially when having to deal with many different industries. Measures need to be put in place to ensure good working relations with tax officials who are experts in particular industries, and tax officials in the various regions where transfer pricing issues may arise, including by regular meetings and formal “contact” points on both sides. This will help ensure the best realistic capability is achieved as soon as possible in terms of educating taxpayers and the administration on transfer pricing; responding to taxpayer requests; identifying compliance issues and their links to other tax issues; and addressing those issues.

29. [C.5.5.5.] It is very important to bear in mind the taxpayer service aspect of the work: the taxpayer should be able to go to a “one-stop” contact point to deal with all issues relating to transfer pricing. That contact point should in turn be responsible for the internal coordination, rather than the taxpayer in effect being forced to act as coordinating agent for the administration. This also helps to promote broader consistency and coherence within the administration.

30. [C.5.5.6.] The benefit of a “one stop” contact point is also one reason why many administrations have large taxpayer offices (LTOs), often with specific industry contact points, to handle relationships with MNEs and other large taxpayers especially in key sectors of the economy such as resource extraction. These offices can respond in an integrated fashion to diverse issues across different subject areas (for example: income tax, VAT and resource royalties) as well as issues of particular importance for some taxpayers such as transfer pricing and thin capitalization. They usually have auditing, registration, tax accounting, collection and taxpayer service roles and are sometimes seen as especially useful when implementing new approaches, including major policy or administrative reforms such as self-assessment or computer modernization of the tax office as an “incubator” for change elsewhere.

31. [C.5.5.7.] In a monitoring and intelligence gathering sense, this sort of structural approach can also enable more proactive analysis and action to deal quickly with emerging issues, such as unexpected falls in revenue from key industries or segments. Such falls may merely reflect economic conditions but could,

alternatively, reflect new compliance risks, such as a rise in “treaty shopping”. Finally, reform of the administration as a whole may be a long-term project, because of a systemic need for skill development or integrity issues that need to be remedied. For example, it is sometimes considered that assembling a well-functioning, trusted and skilled large taxpayer office is the quickest way of safeguarding and monitoring key sectors of revenue while preserving relationships with taxpayers. This experience may also provide lessons that can be applied to the reform of the administration more generally.

32. [C.5.5.8.] Many countries adopt a highly centralized model for their transfer pricing unit at start-up. This reflects the importance of coordination and uniform approaches at that time; it also recognizes that a transfer pricing unit is not designed to have a specific lifespan but rather will become a permanent part of the tax administration’s structure. Several models can be used to take transfer pricing capability further after this start-up phase. It is possible to create teams for every region that can exclusively deal with transfer pricing cases, for example. National coordination is then achieved by placing team members from each region on a rotation basis to work together and discuss the latest developments in transfer pricing.

33. [C.5.5.9.] Another model is to make all corporate income tax inspectors responsible for all transfer pricing cases. In that case it is sensible to appoint some regional focal points which have to be aware of all major issues and are responsible for contacting and informing policymakers.

34. [C.5.5.10.] As noted above, some countries also have a separate office dealing with large MNEs because of their specific characteristics, their relevance in terms of investment, the tax revenue they may generate, and the related tax issues that are of special importance. Such an office can be organized on a national level or within the regions, depending on the number of MNEs that are active in the country. As noted above, this unit should as far as possible act as a central contact point (or “one-stop shop”) for responses on MNE issues and it will therefore need to contain transfer pricing expertise or at the very least work especially closely with the transfer pricing unit.

C.2.6. Building Team Capability

C.2.6.1. General Human Resource Management Issues

35. [C.5.6.1.1.] A new transfer pricing regime may often be created as part of major changes within a tax administration, such as recognition of the impact of globalization and international value chains on the particular country. As with most changes there are potential advantages and disadvantages. While the human resources management strategy for the unit needs to be integrated with the organization’s wider human resources strategy, there are aspects that are likely to be of particular relevance in this area, including the importance of:

- The unit’s “culture”, focusing on achieving the organizational vision, mission and objectives; motivating and providing incentives for performance; measurable goal setting; and mutually agreed and annually updated performance objectives and standards. In a new team, possibly with some reluctant but very capable members, the importance of this work and of good team leaders should not be underestimated;
- Broadly trained officers who understand the importance of investment for a country’s development (including the importance of avoiding double taxation) and understand the drivers and environment of business, yet believe not only in the crucial importance of collecting the country’s appropriate tax take but also in the necessity of public confidence in the integrity of the system and in their actions as tax officials;
- Internationally focused officers (including those familiar with the languages most used by international business) who meet routine business needs but are proactive, creative and adaptive to new ideas and challenges, seeing change as an opportunity;

- Officers who are keen to develop and to explore the most efficient and effective ways of doing their work and are patient in dealing with the large demands, complexity and often slow progress of transfer pricing cases rather than seeking to “cut corners”;
- A strategy for the identification and development of managers who are respected, have integrity and can motivate staff and help them share the vision of the unit and the organization;
- Recognizing that not all will want to be, or can become suitable as, managers, a strategy for recruiting and retaining technical leaders will also be necessary. This strategy can be furthered by discussions, rulings, meeting clients in teams and forming a database of experience—not to be used blindly, but to encourage ways of analysing and reaching conclusions; and
- Clear career prospects and incentives (such as learning opportunities and secondments) for successful officers, based on performance assessments that are fair and based on objective criteria reflecting the objectives of the unit. This means that excellent taxpayer service should be rewarded, not merely activity that appears to be more directly revenue generating. In particular, there are clear dangers in incentives based mainly or wholly on the level of adjustments made, as this can encourage unjustified adjustments. In any case, it may take years to establish whether an adjustment was justified or not, perhaps long after the officer has moved on. Such unjustified adjustments are, in fact, counterproductive to the success of the unit in establishing confidence in the system and providing taxpayer service.

36. [C.5.6.1.2.] Practice has shown two particular human resources-related risks at this stage. First, there is the possibility of resentment against those involved with transfer pricing policy and administration by others in more “established” areas. Because it is new, people within the organization do not always know exactly what it is about and feel uncertain. They can be unwilling or dismissive about taking up transfer pricing issues. Further, setting up a transfer pricing unit may require the recruitment of outside expertise in key roles. Existing staff may feel it is a “fashionable” area of work that draws resources and support away from their own equally important areas of work, or unduly rewards “outsiders” and “upstarts” who have not “paid their dues”. The interrelationship and equal importance of different aspects of the organization’s mission and vision need to be emphasized and “buy-in” established with other parts of the organization. However, it has to be stressed that building up capability in this area will involve new approaches and bringing in some fresh perspectives and new skill sets. The unit should not have a sense of superiority as part of its culture, but rather a sense of the importance of its work and of the opportunities to pursue broader organizational goals while furthering personal development.

37. [C.5.6.1.3.] The link can be established between an effective transfer pricing response and a more effective response by the organization to more general tax issues. Efforts can be made to have transfer pricing information and training sessions for officers elsewhere in the organization. This can reduce any impression that transfer pricing is a “black box” known only to members of the transfer pricing unit (or, even more importantly, that the unit and individual unit officers want to keep it that way) and can emphasize natural linkages to the other work of the administration, such as thin capitalization or treaty negotiation and administration. Conversely training in how particular industries operate, especially ones that are especially large in a country, proportionate to other industries (such as mining, oil and gas, or telecommunications in many countries) will greatly help increase the effectiveness and focus of transfer pricing experts.⁹¹

⁹¹ Alexandra Readhead, *Preventing Tax Base Erosion in Africa: A Regional Study of Transfer Pricing Challenges in the Mining Sector* (Readhead, 2016), Natural Resource Governance Institute, July 2016, p. 26. Available at http://www.resourcegovernance.org/sites/default/files/documents/nrgi_transfer-pricing-study.pdf.

38. [C.5.6.1.4.] There is, on the other hand, a risk that employees from the tax administration will become overly enthusiastic about transfer pricing as a “panacea”—a solution to all problems—and may, accordingly, propose unjustified or disproportionate tax adjustments leading to time consuming litigation and MAP proceedings. It is often stated that transfer pricing is not an exact science, and there is a broad range of possibilities to discuss and adjust tax returns. That inexact quality can be abused by authorities as well as by taxpayers. It is thus important to manage this process, and ensure that any proposed transfer pricing adjustment is justified on purely transfer pricing grounds; it is also important to show that the discretion implicit in such an inexact situation is properly exercised. This involves integrity issues and it is important that decisions taken having major financial impact are appropriately checked and “signed off” in a way that not only ensures (as far as possible) that they are made for the right reasons and consistently with the treatment of other taxpayers, but that they are also seen as doing so.

C.2.6.2. Competences/Skill Sets Needed by the Unit: Putting Together the Best Team

39. [C.5.6.2.1.] Recognizing the many aspects of transfer pricing and that the unit will have educative and taxpayer service functions as well as an enforcement role, a transfer pricing unit should ideally include, or have ready access to, the following skill sets:

- Team and project managers—people with demonstrated ability to put together new teams, whether or not they have specific transfer pricing expertise;
- Economists;
- Lawyers;
- Accountants;
- Auditors;
- Database experts;
- Business process experts (using information technology to evaluate, automate, integrate, monitor and help improve business processes); and
- Those with special public relations and communication skills, including the ability to: listen actively and effectively, solve problems, explain complex issues in terms that are readily understandable and act “diplomatically” with a view to longer-term productive relationships. The increasing scrutiny of transfer pricing policy and administration in most countries makes this especially important.

40. [C.5.6.2.2.] These various skill sets should be bound together not just by technical knowledge and willingness to learn, but also by a common identification with the unit and wider administration’s objectives and ways of doing business. In addition, a deep understanding of what drives business and how it organizes itself to meet its own objectives needs to be internalized in the unit’s work. Having regular access to such skills is the ideal situation of course, and many countries with fairly new transfer pricing regimes have of necessity focussed initially on legal, economic, accounting, audit and database skills.⁹²

41. [C.5.6.2.3.] Dealing with MNEs demands specific characteristics and competences. Transfer pricing is about how business operates and the application of complex tax laws and economic principles to those business operations. Knowledge of international taxation and good judgment is required to select the right areas to focus on and the right cases for an audit, as some transactions are more tax-driven than others. The ability to interpret information, and to sort the relevant from the irrelevant is becoming ever more important as the opportunities to obtain information from other tax administrations and from MNEs themselves increases. Having information available but being unable to properly interpret it may put an

⁹² Readhead, 2016, p. 24.

administration in a worse position, especially before the courts, than if it never had access to the necessary information.

42. [C.5.6.2.4.] Staff with a background in accounting have often been regarded as easy to train in transfer pricing as they are often enthusiastic about specializing in this field, but similar enthusiasm can be found in those with other skill sets. Others, such as lawyers and economists have special skills in dealing with the often complex law and economics of transfer pricing cases, and one of the challenges in this area is having all those skills working together effectively.

43. [C.5.6.2.5.] At the initial stages, specific transfer pricing expertise may not be generally available in the country (or at least within the administration) and will in large part have to be developed. At a later stage expertise from outside may be encouraged to join the tax administration by job gradings that reflect the scarcity of skills and good salaries—perhaps higher than usual salaries, although that can create resentment among other staff. Other non-financial incentives may be important, such as the ability to work on the governmental “side”, perhaps with greater policy or legislative exposure and improved lifestyle (by creating a more balanced work environment for those with children, for example). Developed countries may be willing to place one of their experts in a developing country as a component of Official Development Assistance (ODA) or to sponsor a promising officer from a developing country in a placement within their administration.

44. [C.5.6.2.6.] In one study the value was noted of having embedded experts seconded from other countries (sometimes the same official a few times each year) who have confronted similar problems and developed pragmatic approaches to deal with them.⁹³ It was noted that such experts can share their experience and give auditors, for example, more confidence in demanding information from taxpayers.⁹⁴

45. [C.5.6.2.7.] A key challenge of working closely with taxpayers is that many of the best trained experts from the tax administration are likely to eventually leave to join the private sector. This will have an effect on individual cases as well as on the operation of the unit more generally. As noted in more detail below, a system designed to capture and spread knowledge of transfer pricing issues within the unit, which includes team involvement, effective management, and regular review of cases, will help to minimize the effects of these departures, as will an effective system of recording and filing relevant transfer pricing opinions and material relating to particular cases. In any case, such interplay of “cultures” between the administration and the business sector over time can be useful for each of these entities; it helps each to understand what drives the other and what the expectations are.

46. [C.5.6.2.8.] In addition to technical expertise, “soft skills” are also important for officers to perform their duties. Negotiation and communication skills are essential since transfer pricing demands a great deal of interaction with MNEs. There is always a range of possible outcomes in transfer pricing and room for discussion. Skills that help make these discussions as professional and effective as possible are an important component of a successful transfer pricing unit.

47. [C.5.6.2.9.] Integrity issues may arise from the close contacts between business and the tax administration, the large amounts of money often at stake, the fact that transfer pricing requires the exercise of discretion and judgment in determining appropriate outcomes, and the fact that transfer pricing analysis often gives a range of results rather than a single clear answer. These issues can be exacerbated by a trend of many tax officials engaged in transfer pricing issues later moving to the private sector. The best way to deal with these issues is by having discussions with MNEs in teams, and ensuring that records are kept of those discussions. The records should be internally reviewable to ensure that the proper policies and practices have been followed and to make sure a consistent approach has been adopted between

⁹³ Readhead, 2016, p. 25.

⁹⁴ Readhead, 2016, p. 25.

taxpayers. This helps to ensure that working arrangements are transparent, open and incorporate built-in checks and balances that will reduce the risk of temptation on both sides. It is also important to recognize that officers should be given protection from false accusations against their integrity, which may reduce their willingness to approach each case fairly and impartially. The checks and balances should be designed to support officers acting properly and maintain the effectiveness of the unit. A way for officers to bring issues of integrity to management attention through secure channels that will act on such intelligence without punishing the whistle-blower and discouraging such behaviour in future should also be considered.

48. [C.5.6.2.10.] Regular internal audits of the members of the unit can form part of the system of checks and balances. These audits could include reviews of quality, consistency and timeliness of decisions as well as, possibly, of personal assets of individual officers (such as by declarations of assets and interests and checks as to their accuracy). If resources allow, some form of double-checking of audits including rotation of fresh auditors into such roles can prove to be useful in this respect.

49. [C.5.6.2.11.] A review process of important cases by a formal panel or informal reviews by a senior group is suggested as a way towards achieving coherence, adherence to administration rulings, integrity, sound technical standards and effective case management. This can also, to some extent, form part of the on-the-job training. Those undertaking the review should ideally comprise not just officers from the unit, but also from other relevant areas. The group could include officers dealing with the type of business or industry (such as officers from the large taxpayer office if it is separate), intelligence officers, officers from the economic unit (if there is a separate pool of economists working on transfer pricing issues but not part of the transfer pricing unit—an issue discussed below), tax treaty experts and those dealing with potentially related areas, such as thin capitalization. This need for checks and balances is likely to assume even greater importance in coming years, with greater scrutiny of transfer pricing issues by civil society and parliaments likely in most countries over the coming years.⁹⁵

50. [C.5.6.2.12.] A well-functioning transfer pricing unit needs both legal and economic expertise and it is not purely one or the other. Transfer pricing knowledge is about pricing, economic rationale, market knowledge, and business and industry knowledge. It is, however, also important to understand international taxation issues and the tax rationale underlying relevant transactions.

51. [C.5.6.2.13.] There are sometimes questions as to whether a group with a specific professional specialization, such as economists, should be distributed within other teams or should comprise, at least in the start-up phase, a separate unit. Some of the same issues arise as in the set-up of a transfer pricing unit as a whole. The advantages of distributing economic expertise more broadly (as an example) are that economic issues are treated as just one aspect of the transfer pricing regime. As such, economics expertise is spread more broadly within the tax administration, and the economic perspectives are more easily integrated into the work of multidisciplinary teams.

52. [C.5.6.2.14.] The advantages of a separate pool of economists, on the other hand, are that greater “quality control” can be exerted, especially in the start-up phase, over the consistency of economic analyses. Further, economists in a new area can discuss new issues and learn from each other more easily. As with any specialist skill, having economists working in groups at the start-up phase may also be seen as promoting integrity and an “aligned” and consistent approach to the issues that arise.

53. [C.5.6.2.15.] Whichever approach is adopted, efforts will need to be put in place to ensure sufficient linkages and knowledge exchange between the “pool” of economists and their fellow economists in other areas, as well as other officials that will be part of multidisciplinary transfer pricing teams. It may also be a good idea to consider developing a separate pool of risk assessment officers.

⁹⁵ See, for example, the discussion in Readhead, 2016, pp. 36-38.

C.2.6.3. Training

54. [C.5.6.3.1.] In some countries the educational system provides a steady supply of accountants, auditors, economists and lawyers from which the tax administration can draw. In other countries the situation is more difficult either because the formal educational system does not produce enough qualified graduates or because there is more competition, especially on salaries, from the private sector. This will affect the type of training required and it is of the utmost importance to assess the knowledge, capabilities and competencies of officers.

55. [C.5.6.3.2.] In developing what might be called a “learning plan” for the unit and its individual officers, it is recommended to first develop an assessment of the existing capabilities. This cannot be done without a context, and that context must be the short-, medium- and longer-term objectives of the unit, so it is essentially a “gap assessment”. Such an assessment considers what needs to be done to go from the current capability to the desired future capability. It will address how to achieve the objectives at various stages of the life of the unit and under various scenarios.

56. [C.5.6.3.3.] This assessment should be followed by setting up a training programme to operationalize its recommendations. For a start it is good to first have a group of experts with accountancy and legal backgrounds. The pioneer group to be trained should consist of senior tax officials from the administration (and preferably also from the policymaking area). They are the pioneers and champions who should instil awareness in their colleagues of the importance of a transfer pricing capability. They will organize lectures and in-house seminars to train those officials who will become the next group of experts and to increase their skills and knowledge.

57. [C.5.6.3.4.] Specialist courses will be an important aspect of the training programme. As transfer pricing is a highly specialized expertise, in-country training from international experts and perhaps some training of experts overseas will be needed, with a plan to ensure they disseminate their new learning more broadly upon return (such as adopting a train-the-trainer approach). As with any training, it needs to be demand-driven, to respond to the needs of the transfer pricing unit, to speak to their current level of understanding and take it forward, and ensure commitment. Demand-driven training also requires that those demanding the training are made aware of such opportunities for improving their capabilities and performance (as well as job satisfaction) by undertaking targeted training. International development agencies, regional tax administration groupings, international organizations and training institutions may be willing to assist with this.

58. [C.5.6.3.5.] The next step is to extend this transfer pricing knowledge and expertise to the rest of the organization. A possible model is to train several employees, who are given the appropriate level of authority, in each region with the right skills and make them responsible for further training as well as operational activities. However, the disadvantage is that other tax officials may resent this group, especially if they are given financial and non-financial incentives, as sometimes happens. In this initial period, it is expected that only a few cases will be dealt with; but transfer pricing experience is nonetheless being developed. These specialists should meet with policymakers to share the latest developments and discuss what is happening in other countries. The policymakers will see what the major issues are and have early warning of issues on the horizon that may need swift but considered policy responses.

59. [C.5.6.3.6.] In the meantime, the same approach can be adopted to train the next generation of specialists. The ultimate aim is that all corporate income tax specialists are able to handle at least some aspects of transfer pricing cases. Before that is achieved, as large as possible a group of those dealing with MNEs needs to be able to at least *identify* cases where there is a transfer pricing issue, for further consideration by specialist transfer pricing experts. Even though they may not know all the answers, they will be able to identify issues and will know where to go to find the answers. Additionally, their involvement in this process will help enhance their knowledge.

60. [C.5.6.3.7.] Training should not be merely on transfer pricing issues, of course, as expertise in how a particular industry operates, including the value chains it utilizes, can be especially important if a transfer pricing expert operates predominantly in relation to that industry.⁹⁶ Training in management, negotiation and inter-personal/relationship building skills will also be very important. So too will be knowledge management, project planning, database and other IT skills. Ethics training can be helpful in ensuring that officers are aware of ethical considerations in their new role as well as more formal legal rules of conduct, and of the way in which these interact (especially as to the exercise of discretion).

C.2.6.4. Research Materials/Databases

61. [C.5.6.4.1.] The unit should have access to basic transfer pricing books and, if finances allow, a subscription to a dedicated transfer pricing journal dealing with current issues of interest to countries. As noted elsewhere in this Manual, databases are used by administrations, taxpayers and their advisers when searching for and evaluating possible comparables. They can be used to analyse materials such as:

- Company annual reports;
- Auditor's reports;
- Profit and loss accounts;
- Notes to the accounts;
- Balance sheets;
- Materials indicating the nature of related party transactions;
- Materials indicating the nature of the business; and
- Materials indicating profit margins.

62. [C.5.6.4.2.] Such databases can provide access to private company data not on the public record, as well as public company data. They can also be helpful in systematizing how the data is used, in keeping a record of what is looked at, who has looked at it, and what decisions have been taken, in serving as a way of ensuring documents are readily accessible and searchable, in providing regular backups, and in providing a help-desk function that may have an educative role.

63. [C.5.6.4.3.] Private databases tend to be expensive, although sometimes an introductory price can be negotiated that is much lower than the usual pricing. It cannot of course be presumed that the low price will always be offered. One caution is that relevant data are not available for many developing countries, and the relevance of databases based on other markets and environments has to be carefully considered—adjusting the data to be more relevant to your cases may itself be very resource-intensive. That issue is addressed in more detail in Chapter B.2. on Comparability Analysis.

64. [C.5.6.4.4.] Transfer pricing resources of all types tend to be expensive, and there should be a budget line for such materials in any proposal seeking donor assistance for setting up a transfer pricing regime. The IMF/OECD/UN/World Bank Toolkit for Developing Countries on *Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analysis* addresses some of the issues involved in the use of databases, especially in adjusting comparables from other markets, and some of the skill sets needed.⁹⁷

⁹⁶ Readhead, 2016, p. 26.

⁹⁷ IMF/OECD/UN/World Bank, Discussion Draft: A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyzes, 24 January 2017. Available from <https://www.oecd.org/tax/discussion-draft-a-toolkit-for-addressing-difficulties-in-accessing-comparables-data-for-transfer-pricing-analyzes.pdf>.

C.2.6.5. Information Strategies

65. [C.5.6.5.1.] The unit will need to have access to the necessary information technology hardware and software to enable them to deal with the complexity and volume of transfer pricing-related information, with necessary security measures in view of the commercially sensitive taxpayer information that will be held.

66. [C.5.6.5.2.] Information strategies will be needed to deal with such technology and the way information is held. Taxpayer files need to be held securely but centrally, so that it is clear what has been requested of taxpayers and when, as well as what has been received and when. It should also be clear when materials have been accessed and by whom among the authorized persons, as well as whether information has been downloaded. A data back-up policy will be needed, with measures to ensure that no data are lost if there is a corrupted or lost back-up (such as duplicate backups held in different locations, with the immediately previous backups being retained also). It is important that documents are not lost or destroyed and that the large volume of paperwork that is a characteristic of transfer pricing cases is not overwhelming, but is securely held. The possibility of litigation on transfer pricing issues must always be borne in mind, even though it should be seen by both sides as a last resort.

67. [C.5.6.5.3.] Some countries require material to be provided in electronic form, and others require or encourage an index system for the documents provided and a description of the record-keeping system used. If such information is electronically searchable then, subject to the availability of the necessary software and skills, there are potentially great resource savings in dealing with often very large files, speedier response times, and less chance of information being lost. The cost to taxpayers of providing material in certain forms should always be considered in deciding what should be required under relevant legislation or regulations.

C.2.7. Effective and Efficient Business Processes

68. [C.5.7.1.] Streamlining and simplification of procedures is part of tax administration reform to reduce compliance costs for taxpayers as well as collection costs for administrations. Any such processes being considered in a country should be internalized as part of setting up any transfer pricing capability. This is especially the case because overcomplicated procedures can lead to more informal processes, shortcuts or discretions being used with no legal basis and/or with inconsistency in application between taxpayers. They thus create a severe risk to the integrity of the system as well as increasing compliance and collection costs.

69. [C.5.7.2.] A useful approach is to consider what other administrations do in similar circumstances, especially administrations in the same region, and to follow that guidance unless there are reasons why such guidance is not appropriate after a close examination of the options and the engagement of stakeholders. This approach of looking to what is being done elsewhere as a first point of reference will reduce compliance costs for taxpayers and contribute to a positive investment climate without impacting on the ability to deal with enforcement issues. In fact, it should enhance that ability, as the user can draw upon the practice of other administrations and probably deal with those administrations more effectively because of common starting points.

70. [C.5.7.3.] There will generally be discretions provided in the legislation or regulations of the transfer pricing regime in any case. Such discretions represent a trade-off between a flexible system that takes account of particular circumstances and recognizes the inherent scope for differences in transfer pricing analysis, on the one hand, and the risk that discretion will be exercised inconsistently across similar cases (thus favouring one taxpayer over another) or may raise integrity issues, on the other. Clear guidance for the exercise of discretions and a system of overseeing how they are exercised in practice will be needed.

71. [C.5.7.4.] Owing to the amounts of money at stake in many transfer pricing cases, and perhaps the fact that government transfer pricing experts often eventually leave for the private sector, strong checks and balances are required when decisions are made affecting taxpayer liabilities to tax. On the reverse side, it needs to be clear that the unit is not anti-business, but recognizes the way business inherently operates, the need to follow the law, as well as the need to recognize the duty to provide service to taxpayers and exercise strong enforcement approaches only where warranted and on a fair basis.

C.2.8. Application of the Above Considerations in Implementing a Transfer Pricing Unit and Enhancing Capability

72. [C.5.8.1.] Drawing upon the factors discussed above, the start-up phase of transfer pricing operations requires:

- A critical look at the availability of human resources within the tax administration. Prioritization is essential and choices have to be made concerning the attention to be given to different kinds of taxes. A policy on transfer pricing without sufficient resources being available to the tax administration implementing it “on the ground” will not achieve its objective;
- Definition of the country’s industrial characteristics. It will be useful to look for statistics on trading volumes and other indicators for cross-border transactions. In a start-up phase many countries focus on their main industries (such as mining, pharmaceuticals, telecommunications, breweries and automobiles), and usually on the larger players in the industry in particular;
- Good, professional relations with business. Acceptance and understanding of the policy will reduce compliance and collection costs. Meetings with all stakeholders will help in effectively building and improving transfer pricing policy and capability. This also means less non-compliance is likely to be due to honest misunderstandings of the regime’s requirements, and that there is more current intelligence on existing and emerging issues. This allows more focussed and efficient guidance and enforcement action;
- Understanding what other countries have done at a similar stage, what they are doing now and where that represents an evolution. This can include:
 - Inviting representatives from other countries with a history of transfer pricing to give their views and share their experiences;
 - Reciprocal placements with countries that offer useful experience and are willing to assist can be an excellent way to learn. It will be necessary to first prepare a clear plan of what knowledge is being sought, why the other country willing to host a visit is the right country to learn from, and the expected impact and flow-on effects; and
 - Seeking support from donors to arrange visits to such countries, with rigorous and strategic selection of participants, a strong work programme and an obligation to report on the outcomes and lessons learned. All this will help to ensure that a visit is not perceived, including by the other country or potential donors, as a “holiday” for participants. This can have important additional benefits in personnel management as those who are most open to learning new things and are judged likely to stay with the organization for some time and take transfer pricing technical or managerial leadership roles may be offered such exposure;
 - Exploring the training assistance available from international organizations including the United Nations, the OECD, the World Bank Group, the IMF, and regional organizations such as ATAF and CIAT.
- An ability to define, with policymakers and administrators involved in the process, the important areas of focus bearing in mind:

- The main characteristics of the country's industries, e.g. manufacturers or distribution activities;
- The main kinds of cases contained in the workload of the tax administration;
- The main types of activities to start with in developing policies, recognizing the need for policy to be soundly based in reality; and
- Practical case studies that can provide input for policymaking and a focus for discussing administration issues.

73. [C.5.8.2.] After starting the transfer pricing unit, areas of focus will evolve depending on factors including the stage of development of the transfer pricing policy and the administration. In the first years it is often considered helpful to focus on less complicated activities such as contract manufacturing, intragroup services etc. When a higher level of experience is reached, the focus will often shift to more complicated areas such as intangibles and business restructurings. The same journey has been undertaken by developed countries. However, this does not mean that particularly blatant examples of mis-pricing in these more complicated areas should not be addressed at an early stage.

C.2.8.3. Assessing Effectiveness and Fine Tuning

74. [C.5.8.3.1.] It is best to set up a system of monitoring based on a performance measurement framework that establishes key performance indicators and outputs. While it is important not to overload staff, who will undoubtedly be very stretched for time and resources, with too much paperwork, possible areas of monitoring (some by raw data, some by questionnaires and interviews) include:

- The time schedules involved in transfer pricing disputes;
- Yield from risk-based audits and the percentage of yielding audits;
- Adjustments in tax assessment;
- Ability to respond quickly to emerging issues—including measurable deterrent effects on taxpayer behaviours;
- The number of Mutual Agreement Procedures (MAP);
- Effectiveness of education campaigns and ongoing contact with business groups and their advisers, as well as evidence such as increasing traffic to the website;
- Percentage of correspondence and telephone calls dealt with according to previously established customer service standards;
- Total administration costs of the unit as a percentage of gross collection;
- Improvements made to process, as well as legislative improvements that have arisen out of the areas of work;
- Training undertaken and given, and the measurable impact; and
- Evidence of sharing best practice with other government departments and other tax authorities as part of a continuous improvement strategy.

75. [C.5.8.3.2.] As with any such measurement process, if data that is collected is not being used by management to assess progress the reasons should be considered and the data requirements modified or the use of the data improved. In other words, the process of review should itself be reviewed for effectiveness on a regular basis.

C.2.9. Country Examples of Capacity-Building in Transfer Pricing

76. [C.5.9.1.] **Japan** started its transfer pricing administration with a small unit in the late 1980s. Once the National Tax Agency (NTA) identified the rapidly increasing needs for transfer pricing management it expanded a nationwide training course for international taxation step-by-step, now reaching approximately 100 trainees every year; and also reorganized and gradually expanded the national and regional examination division. Currently the headquarters has transfer pricing sections and the MAP office, while the four major regional bureaux have special divisions for transfer pricing (including two divisions specializing in APAs). Although some essential documentation concerning transfer pricing is required by statute to be translated into Japanese, transfer pricing specialists are generally equipped with sufficient language skills to conduct examinations of the original accounting books, documents etc. in English.

77. [C.5.9.2.] In **India** capacity-building has taken place mainly through on-the-job-training. The Directorate of Transfer Pricing has expanded given that the numbers of cases being referred for audit are increasing annually since 2004, when the Directorate was set up. The National Academy of Direct Taxes, the apex body responsible for training, has been conducting specialized training for officers. The Directorate has organized seminars and conferences for experience sharing by officers engaged in audit and for capacity-building of officers joining the Directorate.

78. [C.5.9.3.] In **Malaysia**, the Inland Revenue Board Malaysia (IRBM) responded to the rise in issues pertaining to cross-border related party transactions in audit and investigation cases by setting up the transfer pricing audit unit, known as the Special Audit Unit, on 1 August 2003.

79. [C.5.9.3.1.] The unit began operations with five officers based in the IRBM headquarters, reporting to the Director of the Compliance Department. From 2004 to 2009 IRBM also had two auditors based in each of the Penang and Johor state offices to deal with transfer pricing cases with the assistance of the Special Audit Unit. By 2007, transfer pricing cases had become increasingly challenging and the Special Audit Unit had grown to 12; however, it was found that transfer pricing issues were still being taken up by other branches resulting in lack of uniformity in the methods used to settle cases. IRBM then decided that transfer pricing audit activity needed to be centralized in order to increase officers' expertise as well as to ensure a standardized approach.

80. [C.5.9.3.2.] The IRBM Multinational Tax Department came into existence with the introduction of transfer pricing regulations under Section 140A and Section 138C of the Income Tax Act 1967 which came into effect on 1 January 2009. In 2008, measures towards centralizing transfer pricing activities were proposed and eventually came into force on 1 March 2009 when the unit became separated from the Compliance Department into a full department of its own. The Multinational Tax Department, headed by a senior director, now reports directly to the Deputy Director General of Compliance. The department is still relatively small, as the intention behind the set-up is to build expertise in a small group who will later be dispersed to provide assistance and knowledge to other branches within IRBM. In general, the Department has four divisions as follows, with individual division directors:

- Policy Division (one auditor), responsible for matters pertaining to regulations and procedures;
- Multinational Audit Division (eight auditors), which conducts audit visits;
- Compliance Audit Division (four auditors), which monitors compliance of cases previously audited; and
- Advance Pricing Arrangements Division (one auditor) which deals with the application and processing of APAs including bilateral and multilateral APAs.

81. [C.5.9.3.3.] Auditors were sent to various training events both inside and outside Malaysia from the initial set up of the Special Audit Unit. The Department continues to send auditors to various courses to

increase knowledge and expertise in transfer pricing issues, as well as having the opportunity to share their own knowledge and experience within the transfer pricing community more generally.

82. [C.5.9.3.4.] In **Kenya**, whilst resourcing and skills challenges remain for Kenya Revenue Authority (KRA), active measures have been taken by the KRA to build capacity in its transfer pricing unit by equipping the unit with the enough experienced staff with required set of skills, capacity building through continuous training and re-tooling and maintaining staff motivation through recognition and promotions. through international training and exposure, retaining multi-skilled staff in the unit and continuous re-tooling. Transfer pricing unit in Kenya has a highly skilled transfer pricing teams with different specialists including lawyers, accountants, economists and business analysts to ensure an understanding of commercial operations.

83. [C.5.9.3.5.] Kenyan law requires taxpayers to keep records for a period of 5 years, it requires specified persons to keep and retain the records, books of account or documents prescribed in the schedule to the notice. Assessments cannot be issued for any period beyond five years unless there is fraud or tax evasion schemes.

84. [C.5.9.3.6.] The main challenge that Kenya has in determining arm's length profits been lack of domestic comparables. There are no databases containing Kenya specific, or for that matter, Africa specific, comparable data. As a result, both the tax administration and taxpayers rely on European databases to establish arm's length levels of profitability. Challenges have been experienced in making adjustments for geographical differences or country risks adjustments (for example, market, economic and political differences).

85. [C.5.9.3.6.] Building on the practice followed in India and China, KRA is currently considering its approach to location savings, location specific advantages and market premiums within certain industries and those factors will be addressed when conducting audits.

86. [C.5.9.3.7.] Concluding, the arm's length principle presents several challenges in terms of application for a developing country like Kenya. The hypothesis required to approximate transactions between related parties to what would have transpired had they been independent can be difficult and as stated, finding reliable comparable and making comparability adjustments is easier said than done. However, Kenya has made tremendous progress on taxation of MNEs by consistent enhancement of its capacity to deal with transfer pricing risks, update of legislative framework and taxpayer sensitisation.

C.4. RISK ASSESSMENT [NOTE: IT IS PROPOSED THAT THIS REVISION OF THE FIRST HALF OF SECTION C.3. IN THE 2017 MANUAL WILL BECOME SECTION C.4. IN THE REVISION OF SECTION C. PARAGRAPH NUMBERS WILL BE CHANGED ACCORDINGLY]

C.4.1. Introduction to Transfer Pricing Audits

1. [C.3.1.1.] This section and the one that follows discuss aspects of transfer pricing audits. This section principally discusses the risk assessment usually performed by the tax administration at the beginning of the audit. The following section discusses aspects of the transfer pricing audit itself.
2. [C.3.1.2.] An effective audit process seeks to achieve two important outcomes:
 - It seeks to enhance and incentivize future compliance (which indirectly contributes to future tax revenue and protection of the tax base); and
 - It seeks to increase current tax revenues through appropriate adjustments to the income reported by taxpayers.

These objectives will be achieved only if the audit is carried out successfully.

3. [C.3.1.3.] Transfer pricing audits are generally time and resource intensive. The hard work involved in a transfer pricing audit may result in the collection of significant tax revenue that can benefit a developing country. However, such results do not come quickly and easily.
4. [C.3.1.4.] The success of an audit often depends on the preparation and planning that take place in the first stages of the audit, especially in the risk assessment phase. Tax administrations do not have the resources to audit every cross border transaction or every taxpayer. Accurate risk assessment enables informed case selection, which in turn helps the tax administration avoid wasting its enforcement resources. It is therefore important to dedicate adequate time and resources to risk assessment.
5. [C.3.1.5.] Risk assessment should be the first step of an audit and should continue through the various stages of the audit. Risk assessment constitutes an ongoing cost/benefit analysis, which helps to ensure the most efficient and effective use of tax administration time and resources and helps to ensure that taxpayers are not unnecessarily inconvenienced when their compliance with the transfer pricing rules is evident. Risk assessment must be built into the auditing process and incorporated into an audit programme.
6. [C.3.1.6.] The OECD has recently published a very useful handbook on transfer pricing risk assessment.⁹⁸ That handbook provides guidance on how the information contained in the taxpayer's transfer pricing documentation can be effectively utilized to assess transfer pricing risks. This chapter does not seek to replicate all of the information in the OECD risk assessment handbook and tax administrations are therefore strongly encouraged to download the OECD handbook from the OECD website and to use it in developing their own risk assessment programmes.

C.4.2. Selection of Taxpayers for Transfer Pricing Examination: Risk Assessment

C.4.2.1. Overview

7. [C.3.3.1.1.] Effective risk identification and assessment are important steps toward ensuring that the most appropriate cases are selected for audit. Given the resource constraints of tax administrations it is important for any tax administration that high risk transfer pricing cases do not “slip through the tax net”. However, even the most robust risk identification and assessment tools and processes may not always guarantee success in audit. The reason for this is that the level of detail contained in information available to the tax administration at the risk assessment stage may not always be sufficient to draw reliable conclusions regarding the arm’s length nature of profits/prices. A determination of whether the prices utilized by the taxpayer are in fact arm’s length will depend on a full functional analysis (based on the risks assumed, functions performed and risks borne by each party), the transfer pricing methods applied, allocation keys selected and so forth. The risk assessment does not involve a full functional analysis. It is instead intended to identify whether such a full analysis is warranted given the constraints on tax administration resources.

8. [C.3.3.1.2.] There are several ways in which a tax administration may conduct its risk identification and assessment, and the approach taken is largely dependent upon the type of information and data that is available and accessible. For example, exchange control authorities in some countries may work hand in hand with the tax administration and sharing of information is strong while in other countries such interaction may be prohibited. Some countries have strong filing and documentation requirements designed to ensure that relevant and appropriate information is submitted. The new global documentation standard described in the section [C.3.], above, will provide most tax administrations with information useful in assessing transfer pricing risk.

9. [C.3.3.1.3.] It is important to draw a distinction here between the information related to filing a tax return and that contained in transfer pricing documentation. This may vary from country to country but in essence is as follows:

- Filing information typically relates to questions on a tax return. This may entail a tick the box (i.e. yes or no) a “fill in the box” response (e.g. inserting a quantum or value);
- Documentation, in the context of transfer pricing, will generally include more substantial information such as answers to questions about the company’s transfer pricing policy, identification of transactions with associated enterprises, legal contracts, invoices, valuations, identification of transfer pricing methods used, publicly reported financial information, etc. For relevant taxpayers, transfer pricing documentation should now also include access to the CbC report reflecting income, taxes paid, and certain measures of economic activity on a country-by-country basis.⁹⁹

10. [C.3.3.1.4.] A risk identification and assessment process followed by engagement with the taxpayer can be a worthwhile approach for tax administrations to adopt. This allows for better understanding of the risks identified and gives taxpayers the opportunity to explain the commercial context of the transactions/risks identified. Such an approach is designed to ensure that the risks have been profiled in the most robust manner before resources are committed to carrying out an in-depth audit.

⁹⁹ The new OECD transfer pricing risk assessment manual provides detailed advice on how the information provided under the documentation standard, and especially in the CbC report, can be used by tax administrations in conducting risk assessments.

C.4.2.2. Categories of Risk

11. [C.3.3.2.1.] Transfer pricing risks arise through intragroup transactions, e.g. payments for goods, services and intangible property, provision of financial assistance and so forth. Such transactions or categories are often readily identifiable on the income statement and/or tax return or from required transfer pricing documentation.

12. [C.3.3.2.2.] It may be useful to try to place the transfer pricing risks into categories in order to give added value and context to the risk identification and assessment process. Such categorization can assist risk profilers/assessors to evaluate the aggressiveness of taxpayer positions and the complexity of the risk, the possible amount of tax at stake, and the probability of generating significant tax revenue through audit. Such classification can assist in determining whether a case is worth pursuing and whether or not the requisite resources and expertise are available.

13. [C.3.3.2.3.] The following describes some of the types of transfer pricing risk that may be considered in a risk:

- Category 1: Profit shifting through newly designed transactions;
- Category 2: Profit shifting through restructuring of business operations;
- Category 3: Profit shifting through incorrect functional classification, the use of incorrect methods, allocation keys etc.; and
- Category 4: Issues involving “thick” or “thin” capitalization.

14. [C.3.3.2.4.] The risk classification provided here as an example can assist the risk profiler/assessor in the evaluation of each of the following factors:

- The likelihood of detection by revenue authorities;
- The possible value or amount of the profit shifting (and therefore the potential value of the risk); and
- The amount of time and resources required to audit the risk (including the level of expertise required from those resources).

Category 1: Profit shifting through new transactions or structures

15. [C.3.3.2.5.] This category includes new transactions and business structures implemented by multinationals with the intention of saving taxes by shifting profits. It is assumed that the potential tax savings for groups implementing these types of transactions or structures may be significant and the tax risk is therefore assumed to be high.

16. [C.3.3.2.6.] Important changes in corporate structure must now be disclosed in transfer pricing documentation. A tax administration’s awareness of possible tax planning schemes and structures and its own analysis of potential loopholes in the tax system may help identify useful lines of audit inquiry.

Category 2: Profit shifting through restructuring

17. [C.3.3.2.7.] This category is different from Category 1 owing to the fact that a tax saving/profit shifting structure is implemented at a certain point in time, resulting in a change to an existing structure or business model. Accordingly, this is referred to as a “restructuring”. The risks associated with a restructuring are different for the various jurisdictions affected. The country where the MNE is headquartered (and possibly where the intangibles were originally developed and/or owned) would face different risks from those faced by a country where the MNE has a subsidiary undertaking manufacturing, distribution or marketing.

18. [C.3.3.2.8.] In this situation the jurisdiction where the MNE is headquartered would face issues relating to the valuation of externalized intangibles, deemed disposals of assets for capital gains tax purposes etc. In addition, the headquarter jurisdiction may have to deal with the classification and benchmarking of profits for the “principal/entrepreneurial” entity remaining or created as a result of the restructuring.

19. [C.3.3.2.9.] On the other hand, the subsidiary jurisdiction(s) in Category 2 would mainly be concerned about risk stripping and profit loss. The primary concern in this regard is that an entity has been stripped of its risks and responsibilities on paper (i.e. contractually), but it continues in practice to carry out the same functions or assume the same risks economically. The entity is effectively being paid less for doing the same things it was doing prior to the restructuring.

Category 3: Other types of intentional profit shifting

20. [C.3.3.2.10.] MNEs may intentionally shift profits through the misclassification of entities, the application of incorrect pricing policies or unsuitable allocation keys. For example, an entity may, during a period of economic upturn, be classified as a limited risk distributor and be rewarded with a fixed (but relatively low) gross margin, when it is in reality fulfilling the role of a fullyfledged marketer/distributor and should be sharing in the economic profits earned by the MNE as a whole. In another case, an MNE could be allocating service charges based on a percentage of turnover as opposed to valuing the actual services performed, thereby extracting profits through excessive service charges.

21. [C.3.3.2.11.] It may be a challenge for a revenue authority to detect the types of intentional profit shifting activity by an MNE dealt with in Category 3. It would for instance require an evaluation of profit margins over an extended period of time against market/industry trends, an in-depth functional analysis of the entities that are party to the transactions and a detailed understanding of the pricing policies. The CbC report may be useful in supporting this type of analysis.

Category 4 Thin and thick capitalization

22. [C.3.3.2.13.] This category of risk includes both intentional and unintentional profit shifting by MNEs using intercompany debt and capital. In most countries, thin capitalization is regulated through safe harbours set at predetermined levels of debt to equity. Where this is the case, the likelihood for risk profilers/assessors of spotting such abuse is high, as these calculations can be easily performed or even automated to flag thinly capitalized entities. Even in cases where countries do not have safe harbours, they can set parameters or thresholds for risk assessment purposes. Risks related to over-capitalisation may be harder to identify and challenge as bright line tests related to excessive capital most often do not exist.

23. [C.3.3.2.14.] The local laws and regulations will influence the level and amount of resources required to audit these cases. Values can range from very low to very high, but their quantification should be simple (in cases where safe harbours or risk assessment thresholds exist). This should be an area of focus for developing countries with simple thin capitalization rules as it could be considered what is often termed “low hanging fruit”—meaning that audit action in such a case may be quickly and easily rewarded by identifying amounts of tax that should be paid.

Category 5: Unintentional profit shifting

24. [C.3.3.2.15.] This category results from cases where mis-pricing by taxpayers occurs but was unintended. A revenue authority may disagree with the pricing policies applied whether it be the functional classification, methods applied etc.

25. [C.3.3.2.16.] Where this occurs it is possible that the values could be material. The level and quantum of resources required to audit the case would depend on the nature and extent of the perceived transgression by the taxpayer, as would the likelihood of detection by the revenue authorities.

26. [C.3.3.2.17.] The following table summarizes some of the types of transfer pricing risk that can be identified in a transfer pricing risk assessment. These factors may suggest the need for additional audit investigation.

Table C.4.1: Possible “Flags” Suggesting further Investigation		
TYPE	INBOUND TRANSACTIONS/MNEs	OUTBOUND TRANSACTIONS/MNEs
Funding	Thin capitalization	Interest free loans
Interest rates	Excessive interest rates	Too low interest rates
Goods	Offshore procurement/sourcing companies to keep profits offshore General mis-pricing (intentional/unintentional)	Offshore marketing companies to keep profits offshore General mis-pricing (intentional/unintentional)
Services	Excessive fees relative to benefit provided Charging when no service received Duplication/shareholder services	No charge at all Excessively low fees relative to benefit provided
Intangibles/Intellectual property	Excessive charges Duplicating charges through royalties over and above inflated prices	Not charging for intangibles developed locally Externalizing intellectual property without reward
Structures	Restructuring New structures	Restructuring New structure To avoid/minimize imputation through controlled foreign corporation Use of offshore branches in low-tax jurisdictions with double taxation treaties

C.4.2.3. Types of Approach

27. [C.3.3.3.1.] There are various approaches that one could take in order to identify companies/groups with transfer pricing risks. These include:

- The transactional approach;
- The jurisdictional approach; and
- The risk-based approach.

Where specific transfer pricing risks are identified, the tax administration can design an audit program that will efficiently investigate whether adjustments to income are appropriate under applicable transfer pricing statutes and regulations.

Transactional approach

28. [C.3.3.3.2.] In order to start building capacity and expertise through on-the-job training it may be useful to adopt a transactional approach under which simpler transactions, which may be easier to price, are audited first. These include, for example, interest-free loans and thin capitalization. These are more easily identifiable but not necessarily easier to audit in all circumstances. For example, due to restrictions on access to information some jurisdictions may face greater difficulty in auditing service transactions whereas other jurisdictions may be able to audit these transactions with relative ease.

29. [C.3.3.3.3.] Alternatively, the focus could be on higher risk transactions with a higher possible revenue yield, such as business restructurings, for example. Finally, examination of a combination of more complex and simpler transactions can be adopted in order to ensure a more consistent flow of work and revenue.

Jurisdictional approach

30. [C.3.3.3.4.] A revenue authority may adopt an approach under which transactions entered into with entities in previously identified tax jurisdictions are prioritized for audit. A crucial element of this approach is the inclusion of both direct and indirect transactions entered into with such jurisdictions, e.g. schemes or structures ultimately benefitting or involving entities in these identified jurisdictions. This will require the transfer pricing unit to identify those jurisdictions it considers to be of higher risk, within the context of domestic tax rates, domestic trade flows and domestic economic policies.

31. [C.3.3.3.5.] It may be that transactions involving related parties in jurisdictions with higher tax rates are flagged for prioritization by tax authorities in the other jurisdiction where those jurisdictions are perceived by MNEs to have particularly aggressive transfer pricing rules or practices. MNEs may apply transfer pricing in such a way that it favours the more aggressive jurisdiction (in order to avoid potential audits in these jurisdictions) at the cost of the jurisdiction where transfer pricing is not as aggressively pursued. In adopting this approach, care should be taken not to act contrary to international non-discrimination rules such as may be found in applicable tax treaties and/or domestic law.

Risk-based approach

32. [C.3.3.3.6.] This is in essence a hybrid of the first two approaches, but could also consider factors other than the jurisdiction of the related party or parties and the type of transactions.

33. [C.3.3.3.7.] Other factors of interest might for instance include:

- The tax compliance status of the local entity or the multinational group to which the entity belongs, i.e. how compliant is the company/group generally or specifically as to transfer pricing in that country or elsewhere in the world. Where groups/entities have been successfully investigated by other revenue authorities this could provide an indication that the group presents a higher risk for transfer pricing purposes;
- A group that has recently undergone a business restructuring, particularly where the local entity has been “stripped” of certain risks and/or functions as part of the restructuring; and
- Companies with excessive and/or continued accounting or tax losses relative to a profitable group outside the country where the risk is being assessed.

C.4.2.4. Sources of Information for Risk Assessment

34. [C.3.3.4.1.] Tax authorities should work as far as possible with the information provided by the taxpayer. The tax return should ultimately aim to obligate taxpayers to include the information that would be most useful for the tax authority to utilize for effective risk assessment. Information provided as part of the taxpayer's transfer pricing documentation will be an important source of information for a risk assessment. The use of quantitative rather than qualitative data will assist in the automation of risk assessment tools. Examples of useful information on transactions include the value of the following transactions of any cross-border related party:

- Sales;
- Purchases;
- Loans, including interest received and/or accrued;
- Royalty payments;
- Service fees;
- Derivatives transactions;
- Debt factoring or securitization transactions; and
- Share remuneration transactions.

Most of this data will be included in the transfer pricing documentation described in section [C.3.], above.

35. [C.3.3.4.2.] Publicly available data is a useful source. This includes newspapers, websites, databases and publications such as "Who owns Whom" or databases of company financial information. Unfortunately, databases and publications in this area can be expensive, and developing countries may often have to be more reliant than their colleagues in developed countries on information provided by taxpayers.

36. [C.3.3.4.3.] Published judgments of cases heard in other countries may contain useful intelligence regarding a group's activities, transactions and pricing policies. These could also provide useful guidance on structures/schemes implemented in certain industries. The analyses of such decisions provided by law and accountancy firms to their clients are often freely available, and can also be helpful in identifying similar issues in another jurisdiction. Access to transfer pricing information databases summarizing and often including the full judgements, such as those issued by commercial publishers, can also be useful, if the cost of at least one licence can be borne by the administration's budget or donor support. Comprehensive transfer pricing databases used in transfer pricing analysis also often have a searchable database of new developments.

37. [C.3.3.4.4.] Particular attention should be paid to any notes to the financial statements on related party transactions and loans/financial assistance.

38. [C.3.3.4.5.] Customs data can, in some cases, be relevant to obtaining information on intragroup transactions. It is sometimes the case that the import price may be an indicator of the true transfer price. See Chapter B.2., Comparability, for more details on the use of customs data for transfer pricing purposes.

39. [C.3.3.4.6.] As noted above, information from the taxpayer's transfer pricing documentation can be very useful. Beginning in 2017 this may include a master file and country-by-country report if the country follows the new BEPS documentation standard. See Chapter [C.3.] for more information on transfer pricing documentation.

C.4.2.5. Risk Factors

40. [C.3.3.5.1.] Certain risk factors or “flags” can point to the need for further examination. They should not be treated as decisive in determining that non-arm’s length pricing has occurred. Instead, these factors point to a higher than normal likelihood of such mis-pricing and suggest that further audit review is warranted.. Identified risk factors may include:

- Consistent and continued losses;
- Transactions with related parties in countries with lower effective/marginal tax rates, especially “secrecy jurisdictions” from which tax information is not likely to be shared;
- Local low profit or loss making companies having material cross-border transactions with related parties offshore, where the offshore part of the group is relatively much more profitable;
- The existence of centralized supply chain companies in favourable tax jurisdictions, i.e. centralized sourcing or marketing companies located in jurisdictions with low-tax or no-tax regimes and which are not located in the same country/region as the group’s main customers and/or suppliers;
- A poor tax compliance history;
- Lack of documentation to support transfer prices;
- Significant inconsistencies between profits of the taxpayer and profits of the group;
- Any significant reduction in local entity profits after such an entity is acquired by an MNE group;
- Material commercial relationships with related parties in jurisdictions with aggressive/strict transfer pricing rules—the corporate group may be more likely to set transfer prices in favour of the more aggressive jurisdiction at the cost of the less aggressive jurisdiction, due to the higher likelihood of intense scrutiny in the first jurisdiction;
- The same applies in the case of material commercial relationships with companies located in the “home” jurisdiction of the MNE or the location where the holding company is listed;
- Similar considerations apply where there are material commercial relationships with companies in jurisdictions that employ safe harbours or similar rules that do not always align to the arm’s length principle.

C.4.2.6. The Risk Assessment Process

41. [C.3.3.6.1.] As stated, the risk identification and assessment process may vary from one tax administration to another depending on the approach taken, the resource capability, the stage at which potential challenges are considered etc. Some tax administrations have very sophisticated processes employing computerized systems etc. while others may adopt a more simplified process. Ultimately the risk identification and assessment process will depend on what a tax administration has at its disposal in terms of information, capability and systems or technology. It can, however, be said that the more refined and sophisticated the risk identification and assessment process, the easier it will be to ensure that high risk transactions are identified and audited in a timely manner.

42. [C.3.3.6.2.] The basic steps of the risk assessment process can be described as follows:

- Initial review and identification of the possible risks;
- High-level quantification of the possible risks;
- Gathering of other intelligence;
- Decision as to whether to proceed;

- More in-depth risk review including high-level review of documentation and functional analysis to confirm initial findings;
- More detailed quantification of possible risks;
- Initial interactions with taxpayer; and
- Decision as to whether to proceed to audit by way of specialist reviews or committee based/panel reviews.

The OECD risk assessment handbook referred to above contains detailed suggestions as to how the risk assessment process may be carried out.

C.4.2.7. Risk Assessment Tools

43. [C.3.3.7.1.] Some of the more common risk identification and assessment tools include calculation templates for thin capitalization and templates for calculating key ratios relevant to transfer pricing. Such tools are relatively basic, based on quantitative information readily available to non-transfer pricing auditors and on transfer pricing documentation. This may include, for example, information available from the tax returns and audited financial statements to assist auditors in identifying (or “flagging”) those cases with probable transfer pricing/thin capitalization risks.

44. [C.3.3.7.2.] Where specialist transfer pricing capability and resources are limited, generalist auditors may be used to assist with risk identification and assessment. In such cases these basic tools ideally do not require generalist auditors to apply their discretion or have specific transfer pricing/thin capitalization knowledge. They merely require the auditors to input certain data, run the calculations (if not automated) and report the results (where above or below certain pre-established thresholds) to the transfer pricing unit. The decision as to whether to involve the auditor going forward is then a decision that should be made on a case-by-case basis by those with special transfer pricing expertise as part of the audit process.

45. [C.3.3.7.3.] Basic quantitative risk assessment tools are particularly effective in the identification of thin capitalization risks as this usually involves a quantitative test of the financial data and is in most cases, depending on the local legislation, a matter of objective fact rather than more subjective opinion. Automated risk assessment tools that can be used to run through large sets of available data can be used very effectively in this area.

C.4.2.8. Risk Assessment Findings

46. [C.3.3.8.1.] It is important that the outcomes of a risk identification and assessment process be documented and signed off for governance and control purposes and preferably saved in a central repository, i.e. a database of cases assessed, whether or not leading to a detailed audit or to tax assessment.

47. [C.3.3.8.2.] The tax administration should design templates containing key information relevant to their domestic requirements. Ideally these should include:

- Statutory filing requirements (e.g. tax number etc.);
- The nature of the transactions and risks identified;
- The quantum;
- The jurisdictions with which the transactions occurred;
- The information reviewed e.g. the financial statements, tax return etc.; and
- The outcome of the risk identification and assessment process, i.e. what was recommended and why.
- Specific issues and transactions identified for further audit.

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C.5. Transfer Pricing Audits.

[NOTE: This new section C.5. relating to tax audits preserves much of the same text as was previously found in section C.3.4. through C.3.8. It has been separated from the material in new Section C.4. on Risk Assessment primarily to keep chapters to a reasonable length while permitting some expansion of the material on risk assessment. Paragraph numbers should be modified to reflect the reordering of the material.]

C.5.1. Planning for a Transfer Pricing Examination

1. [x.x.x.x.] If a determination is made at the conclusion of the risk assessment that a full transfer pricing audit of one or more issues is appropriate, the tax administration should organize an audit team and proceed with such an audit. This section provides an overview of various considerations to be taken into account in conducting a transfer pricing audit.

C.5.1.1. Formation of the Examination Team

2. [C.5.1.1.1.] Where the transfer pricing unit of the tax administration decides to examine transfer pricing, the examination team should ideally be comprised of:

- An overall manager who has responsibility for more than one audit;
- A team leader who will manage the day-to-day examination of a taxpayer;
- A domestic examiner who is responsible for audit activities primarily relating to domestic issues;
- An international examiner who is responsible for audit activities primarily relating to international issues;
- A transfer pricing economist who provides economic analysis and support for the audit;
- A lawyer who is available for consultation on legal aspects and may be involved in audit planning and implementation;
- A computer audit specialist who assists with the software needed to analyse computer readable data received from the taxpayer, and in organizing the data to assist the domestic and international examiners as well as economists in analysing transfer pricing issues; and,
- Where possible the team should also include an industry specialist.

3. [C.3.4.1.2.] The above-mentioned persons may not always be present in one examination team and may be provided as needed depending on the current state of the audit process. One person may also be able to effectively perform two or more of the above functions. It is noted that the above seven different kinds of skill groups illustrate the knowledge and expertise needed for a transfer pricing audit team.

4. [C.3.4.1.3.] The international examiner, the transfer pricing economist and the lawyer are likely to be present in most cases. The international examiners are indispensable in the light of the international nature of transfer pricing. They receive special training in international issues and, in many cases, are more senior and experienced than domestic examiners. The team leader often consults the international examiner.

5. [C.3.4.1.4.] Transfer pricing economists should be involved from the inception of the audit. An economist is almost always involved in:

- The functional analysis of the taxpayer's business;
- Assisting in the selection of comparables;
- Assisting in the selection of the methodology to be applied;
- Providing an analysis of whether the prices for the transactions in question meet the arm's length standard;
- Assisting the audit team with respect to the economic arguments when in discussion with the taxpayer; and
- Preparing or assisting the preparation of a report addressing the conclusions of the team.

6. [C.3.4.1.5.] The lawyer will often be involved at an early stage in reviewing important substantive or procedural decisions. Additionally, the lawyer will be consulted concerning the procedures to be used for information gathering, may be involved in drafting questions posed in information requests and may also participate in interviews of company personnel. The lawyer is expected to contribute to more carefully crafted inquiries for information and to resolve administrative and substantive issues. Also, the participation of the lawyer in the audit process may expedite and make more effective the preparation of the case for possible litigation.

C.5.1.2. Supervision of Examination

7. [C.3.4.2.1.] A key issue for a tax administration is how to ensure transfer pricing audit approaches are uniform over the whole country. This is especially a pressing problem for a country which has a vast geographical area to cover. An illustration of an effort to solve the "uniformity" problem can be seen from the case of Japan.

8. [C.3.4.2.2.] When Japan enacted its transfer pricing tax legislation in 1986, one of the issues was how to administer the transfer pricing legislation uniformly all over the country. There were 12 regional taxation bureaux, while a single unit had to supervise the transfer pricing assessments done by these bureaux. From the outset the rule was established that prior approval from the Director (International Examination) in the Large Enterprise Examination Division of the National Tax Agency had to be obtained before each transfer pricing division could issue a correction notice to adjust transfer pricing of a taxpayer. Such an approval request should be supported by an explanation of the facts of the case and the reasons for the adjustment; transfer pricing divisions were also encouraged to consult the Director (International Examination) during the course of the examination.

9. [C.3.4.2.3.] This was possible at the early stages of transfer pricing enforcement because the number of transfer pricing cases was small. As the number of transfer pricing cases increased, however, it became impossible for the Director (International Examination) to control all these cases. Therefore, gradually, the supervisory power has been delegated to the Senior Examiner (International Taxation) at each regional taxation bureau. The Director (International Examination) now supervises only the larger transfer pricing audit cases. It is now possible to supervise transfer pricing audits at the level of the regional taxation bureaux as the number of tax officials who share common knowledge and expertise in transfer pricing has increased considerably.

C.5.1.3. Issues for Examination/Examination Plan

10. [C.3.4.3.1.] It is necessary to decide what issues will be investigated in a transfer pricing examination.¹⁰⁰ This will be based on the risk assessment and involves the establishment of a transfer pricing examination plan; see paragraph C.3.5.5.1. of this Chapter for further discussion of the examination plan.

C.5.1.4. Audit Timetable

11. [C.3.4.4.1.] A transfer pricing audit usually takes longer than an ordinary tax audit because the scope of the factual matters to be investigated is much broader and the amount of time and effort needed for transfer pricing analysis is much greater. In general, the time needed would be an average of one to two years. Experience has shown that examinations rarely proceed in accordance with the timetables set forth in the examination plan. The main reason is that the progress of an examination depends on whether the information requirements set forth in the examination plan are satisfied. Unfortunately, the required information is not always obtained on time. It may be necessary to check the progress of the audit periodically to reconsider the audit timetable and the extent of information needed by the audit team.

C.5.1.5. Information Already in Hand

12. [C.3.4.5.1.] Tax authorities are already in possession of certain necessary information before starting a transfer pricing audit. These sources form important basic data for a transfer pricing audit and include:

- Tax returns filed;
- Financial statements attached to the tax returns;
- Certain schedules relating to transfer pricing attached to tax returns; and
- Statutorily required information returns and transfer pricing documentation.

C.5.1.6. Information to be Collected

13. [C.3.4.6.1.] The first major activity in a transfer pricing audit is the gathering of information that the tax authorities consider necessary to decide whether to accept tax returns as filed or to propose transfer pricing adjustments. The tax authorities rely primarily on the taxpayer to provide that information.

14. [C.3.4.6.2.] It should be noted that the taxpayer's cooperation in providing the required data is essential in a transfer pricing audit; in this respect it differs from ordinary tax audits. In a transfer pricing audit, the taxpayer is often asked to create data or to put data in order for the audit team. In the case of an ordinary tax audit, the taxpayer has no obligation to create a document for tax examiners. Further, it is often necessary in a transfer pricing audit for the taxpayer to explain the business operations. Taxpayers are expected to cooperate with the audit team in providing the necessary data and explanations, and a cooperative atmosphere during transfer pricing audits is desirable and to be encouraged.

15. [C.3.4.6.3.] The principal means for the audit team to collect the necessary information is the written information request. The information request is usually backed up by criminal or other penalties to be imposed in the case of failure to comply with the request. Multiple information requests are likely to be issued by the audit team during a transfer pricing audit. The time given for responding is usually a few weeks, unless the taxpayer is expected to take a longer time to obtain and/or prepare the required

¹⁰⁰ Transfer pricing audits can also be described as "examination" programmes, though it is also possible to use the term "examination" in a wider sense, e.g. to cover compliance checks of transfer pricing processes without doing a full-scale audit.

information. Tax authorities can also utilize the exchange of information provision in an applicable tax treaty.

16. [C.3.4.6.4.] It should be noted that a common problem is the challenge in enforcing an information request which seeks a document or information not held by the taxpayer under investigation, but held by a related but legally distinct party outside the country. In the case of Japan, the Japanese taxpayer is required to make efforts to obtain the documents and accounting books held by its related party outside Japan. The Japanese tax authorities have the statutory authority to impose presumptive taxation if the requested data is not submitted by the taxpayer.

17. [C.3.4.6.5.] The United States has more forceful means of obtaining documents located outside the country. Firstly, the Internal Revenue Service (IRS) may issue a Formal Document Request (FDR) to a taxpayer to request foreign-based documentation under Section 982 of the Internal Revenue Code (IRC) after normal request procedures have failed. If the taxpayer fails to substantially comply with the FDR within 90 days, it may be precluded from introducing any foreign-based documentation covered by the FDR as evidence at a trial where the documentation is relevant. Secondly, the IRS can request a taxpayer to obtain authority from a foreign related entity to act as an agent of that entity for the purposes of a summons under Section 6038A(e) of the IRC. Where the taxpayer fails to obtain the authorization, the IRS may determine the amount at issue based solely on the information available to it. Thirdly, the Third-Party Summons procedure is available to the IRS under Section 7602 of the IRC. The IRS must provide “reasonable notice” to the taxpayer before contacting any other party regarding the taxpayer’s tax liability and must provide to the taxpayer a list of the persons contacted by the IRS periodically or upon the taxpayer’s request.

C.5.1.7. Statute of Limitations as Provided for in the Domestic Law

18. [C.3.4.7.1.] The statute of limitations period for transfer pricing cases may be the same as, or different from, that for ordinary tax cases. The United States applies the same three-year statute of limitations period to both ordinary tax disputes and transfer pricing disputes. The United Kingdom (six years), Germany (four years) and France (four years) also have the same statute of limitations period for both. On the other hand, Japan applies a statute of limitations period of six years to transfer pricing cases while the statute of limitations period on ordinary corporate income tax liabilities is five years. Canada’s statute of limitations period is six years for transfer pricing cases and three years for ordinary tax cases.

19. [C.3.4.7.2.] Another aspect of the statute of limitations is the fact that in the United States a taxpayer can waive the benefit of the statute of limitations but in other countries including Japan the state of limitations period is fixed and the benefit cannot be waived by a taxpayer.

C.5.1.8. Approvals and Sign-off

20. [C.3.4.8.1.] A transfer pricing audit, once it has started, will require a considerable investment of time and effort by the examiners. It is best to require the approval and sign-off by a superior officer or the committee of transfer pricing audits before the examination starts from the viewpoint of effective use of the tax administration’s human and other resources.

C.5.2. Preliminary Examination

C.5.2.1. Desk Audit

21. [C.3.5.1.1.] As noted above, the tax authorities have certain transfer pricing information in their possession before a transfer pricing audit starts. A desk audit of such information, especially financial

statements, should be made to evaluate whether there are any transfer pricing issues. For instance, computing the following financial ratios based on tax and financial data may be useful:

- Gross profit to net sales;
- Operating profit to net sales;
- Operating expenses to net sales;
- Gross profit to operating expenses (Berry Ratio); and
- Operating profit to average total assets.

22. [C.3.5.1.2.] Comparing the taxpayer's financial ratios to applicable standard industry ratios is useful if standard industry ratios can be found. Substantial deviations from standard industry ratios may indicate a transfer pricing problem. The findings from the desk audit should be analysed to determine what further action, if any, is needed.

C.5.2.2. Understanding the Taxpayers' Business

23. [C.3.5.2.1.] Understanding the taxpayer's business operations is an essential part of the transfer pricing examination. This study can be commenced before starting a transfer pricing audit or even after that time, and should include an understanding of the following:

- The taxpayer's operations;
- The operations of its affiliates (domestic and foreign);
- The relationship between the taxpayer and its affiliates (domestic and foreign);
- Key value drivers in the business;
- The role each entity plays in carrying out the activities and performing the business functions of the controlled group;
- The scope, volume and nature of controlled functions; and
- How much control and direction the taxpayer receives from the headquarters of the group.

24. [C.3.5.2.2.] The following may be useful sources for gaining an understanding of the taxpayer's business operations:

- Transfer pricing documentation;
- Annual reports;
- Securities reports;
- Books and other publications describing the taxpayer's operations;
- Reports published by securities companies;
- Internal audit and management reports;
- Organization charts and business flow charts (the preparation of which may require the taxpayer's cooperation);
- Minutes of board meetings, committee meetings and shareholders' meetings;
- Policy and procedure manuals;
- Internal approval documents;
- Written inter-company pricing policies;
- Customs declaration documents;
- Sales catalogues, brochures, and pamphlets; and
- E-mails, faxes and other written correspondence between the taxpayer and its affiliates.

25. [C.3.5.2.3.] The following questions are among those which may be asked in order to understand the taxpayer's operations:

26. [C.3.5.2.4.] If the taxpayer is engaged in the *distribution* of products:

- Are affiliates manufacturing the same or similar products to those distributed by the taxpayer?
- Is technology transferred between affiliates and the taxpayer?
- Are trademarks and other marketing intangibles being used to market the product?
- Which members of the controlled group developed the trademarks and other marketing intangibles?
- Which members of the controlled group advertise?
- Which members of the controlled group created the sales tools?; and
- Which members of the controlled group created and maintained the list of customers?

27. [C.3.5.2.5.] If the taxpayer is engaged in the *manufacturing* of products:

- Are affiliates distributing or selling the same or similar products to those the taxpayer manufactures?
- Is the taxpayer using the same or similar manufacturing intangibles to those its affiliates are using?
- What patents and/or know-how are involved in the relevant technology?
- Is there a cost sharing agreement?
- Did affiliates or the taxpayer buy into a cost sharing agreement?
- What research and development is conducted?
- What members of the controlled group do research and development?; and
- How are the results of research and development disseminated among members of the controlled group?

28. [C.3.5.2.6.] As intangibles are an important aspect of the taxpayer's business, gaining an understanding of the following *intangibles* may also be useful:

- Manufacturing and marketing intangibles;
- Domestic and foreign patents and any prosecutions involving the taxpayer;
- Licenses and assignments;
- Patent litigation involving the taxpayer;
- Domestic and foreign trademark registration and trademark litigation involving the taxpayer; and
- Copyright registrations at the patent or copyright office.

C.5.2.3. Understanding the Industry in which the Taxpayer Operates

29. [C.3.5.3.1.] The following procedures may be used in order to understand the taxpayer's industry:

- Identifying the industry association;
- Reviewing the industry association's publications and website;
- Reviewing industry guidelines used by the taxpayer;
- Consulting with various industry experts;
- Consulting various books and articles on the industry;

- Identifying competitors in the same industry;
- Comparing the competitors' activities with those of the taxpayer; and
- Comparing the competitors' financial data with those of the taxpayer.

C.5.2.4. Approval

30. [C.3.5.4.1.] The approval of a superior officer will usually be required before embarking on a full-scale transfer pricing audit of the taxpayer when the preliminary examination is completed.

31. [C.3.5.4.2.] The approval process will need to be coordinated with the organizational model of the transfer pricing administration. See Chapter C.2., above.

C.5.2.5. Audit Procedure

C.5.2.5.1. Audit Approach

31. [C.3.5.5.1.1.] The examiners need to establish the transfer pricing examination plan, which may be divided into two parts:

- Part one identifies the audit team, the information they expect to obtain and the timetable for the examination. This part can be disclosed to the taxpayer under investigation; and
- Part two identifies the tax administration's resources to be devoted to the examination, the accounts and transfer pricing issues under examination, the anticipated procedures for the examination of each issue, the personnel responsible for the various steps and the management procedures to be followed by the audit team. The information in part two is generally not disclosed to the taxpayer.

C.5.2.5.2. Notification to Taxpayer

32. [C.3.5.5.2.1.] A transfer pricing audit usually brings the examiners into contact with the taxpayer by phone for scheduling an initial appointment. If such contact cannot be made the examiners will send a letter notifying that they will audit the taxpayer. This is the time when the examiners send the initial information request to the taxpayer. If contemporaneous documentation is required, this is also the time to trigger the period of submission of the contemporaneous documents.

33. [C.3.5.5.2.2.] The audit is usually concerned with transfer pricing aspects only. However, an ordinary corporate income tax audit may develop into a transfer pricing audit if the examiners find it necessary to probe into transfer pricing aspects. The number of taxable years to be covered by an audit depends on the statute of limitations. If the statute of limitations is six years, the taxable years to be covered may be five or six years.

34. [C.3.5.5.2.3.] The examiners will usually suggest a meeting with the taxpayer, where the examiners may discuss the schedule of the transfer pricing audit and certain ground rules. If the taxpayer has submitted certain requested documents the examiners may also discuss the contents of such documents.

C.5.2.5.3. Gathering of Information

35. [C.3.5.5.3.1.] Certain information needed for the transfer pricing audit is already in the hands of the tax authorities:

- **Tax returns:** tax returns of the taxpayer are the most basic information documents;

- **Financial statements:** financial statements of the taxpayer under generally accepted accounting practice (GAAP) are often required to be submitted to the tax authorities together with the tax returns and constitute important financial documents for the transfer pricing audit;
- **Documents attached to the tax returns:** taxpayers are often required to attach to a tax return a document relating to transfer pricing. For instance, in Japan Schedule 17(4) to the final tax return is required to disclose certain information on the taxpayer's transactions with its foreign related persons and it is often a useful information source for a transfer pricing audit. An English translation of this Schedule 17(4) is produced below; and
- **Information returns:** information returns may be required for transfer pricing purposes.

36. [C.3.5.5.3.2.] Other necessary information will be requested by the audit team. The audit team's authority for making the information request is based on the tax authorities' general investigation authority provided for in a country's taxation law. Furthermore, certain countries have specific statutory provisions for requesting information regarding transfer pricing issues.

37. [C.3.5.5.3.3.] It is useful to interview the personnel of the taxpayer engaged in marketing and sales and those in the accounting and financial departments. See Section C.3.5.5.10. for more details.

38. [C.3.5.5.3.4.] It is often useful to visit a sales shop and a factory of the taxpayer to understand the taxpayer's business. During the audit, the audit team may want to arrange this visit with the taxpayer. See [C.3.5.5.11.] for more details.

39. [C.3.5.5.3.5.] Necessary information can also be collected from other sources such as the taxpayer's website, the taxpayer's submission of periodic financial data to the securities regulatory agency (if the taxpayer's shares are listed on a stock exchange), business journals, other tax filings (related and unrelated to the taxpayer) etc. If the information is publicly available, the audit team can freely use the contents of such information but if it is confidential the audit team must exercise care in disclosing such information.

C.5.2.5.4. Sources of Information

40. [C.3.5.5.4.1.] The principal information source is the taxpayer. The taxpayer's books, records and other written documents, and its directors and employees are the principal sources of information.

41. [C.3.5.5.4.2.] A former employee or director of the taxpayer may also be a source, if necessary. In this event the former employee or director may be bound by a contract with the taxpayer not to disclose any secret information. This often causes a difficult legal question as to whether the former employee is obliged to disclose the requested information to the tax authorities. This question must be resolved in light of the domestic law of the country concerned.

42. [C.3.5.5.4.3.] A third party is also a possible source of information. For example, Japanese tax law authorizes the Japanese tax authorities to request information from a corporation engaging in a business activity which is of the same type or examine the accounting books and documents of that person or corporation.¹⁰¹ Tax returns of a third party in the same business will also be useful sources of information. When a third party's information is used the tax authorities are confronted with a statutory obligation of confidentiality when dealing with the taxpayer. This is often discussed in the context of secret comparables.

¹⁰¹ Japanese Special Taxation Measures Law Art. 66-4, paragraph 8.

C.5.2.5.5. Language

43. [C.3.5.5.5.1.] The documents a taxpayer possesses with respect to its transactions with a foreign related party are often written in a foreign language that tax auditors may not understand. Tax law in most countries is generally silent as to which side should translate the foreign language documents necessary for transfer pricing audit. If the documents are voluminous the cost of translation is substantial.

44. [C.3.5.5.5.2.] When the relevant documents are written in a foreign language the examiners frequently request the taxpayer to translate the foreign language into the domestic language at its own cost, and the taxpayer is often cooperative as a matter of practice. However, the legal basis for the practice is not always clear.

45. [C.3.5.5.5.3.] If a document necessary for a transfer pricing audit is written in a foreign language and cannot be understood by the examiners, it will generally be the party with the burden of proof that will suffer a disadvantage.

46. [C.3.5.5.5.4.] The English language may have a unique position as a foreign language in this context. In most non-English speaking countries tax examiners in charge of transfer pricing taxation are trained to understand English and may be able to read documents in English.

C.5.2.5.6. Types of Information to be Gathered

47. [C.3.5.5.6.1.] General information required for a transfer pricing audit includes:

- A corporate profile;
- The organization of the taxpayer and the related parties;
- The transactions or business flows;
- A list of manufacturing and/or sales facilities;
- A list of directors and employees; and
- A diagram of group affiliates with capital relationships.

Much of this information can now be found in the taxpayer's transfer pricing documentation, assuming it has been prepared in compliance with the global standard described in Chapter C.3.

48. [C.3.5.5.6.2.] The taxpayer's financial statements provide basic financial information. However, the transfer pricing audit is often focused on the sales or purchases of particular products, the provision of particular services or the licensing of particular technology. It then becomes necessary to segment revenues, expenses, gross profit and/or operating profit. A segmentation of the profit and loss statement is thus often conducted, focusing on transactions under review by the tax auditors. The preparation of segmented profit and loss statements will require additional work by the taxpayer who knows the details of the profit and loss statements. The accurate review and assessment of the financial results will often be impossible without segmented profit and loss statements.

49. [C.3.5.5.6.3.] Third party information required is basically comparable data. The sources of the third party information may vary depending on the possibility of finding appropriate comparables. See further Chapter B.2. on Comparability Analysis.

C.5.2.5.7. Points for Examination at the Initial Stage

50. [C.3.5.5.7.1.] In order to correctly ascertain whether any issue exists in relation to the transactions in the examination process, each case should be examined carefully, bearing in mind the circumstances of each transaction. In conducting a transfer pricing audit, the following points should be taken into

consideration along with the functions performed, risks assumed and assets used by the taxpayer and by the persons compared:

- Whether the gross and operating profit margins arising from related transactions of the taxpayer are excessively low compared with those of other transactions conducted by the taxpayer with unrelated persons in a similar market and which are similar in quantity, market level and other respects;
- Whether the gross and operating profit margins arising from related transactions of the taxpayer are excessively low compared with those of other unrelated persons engaged in the same category of business that are similar in quantity, market level and other respects; and
- Whether the taxpayer's gross and operating profit margins arising from related transactions are relatively low compared with those of the related persons arising from the same transactions.

51. [C.3.5.5.7.2.] Prior to the calculation of arm's length prices, examinations should be conducted from different viewpoints in order to determine whether there are any issues regarding transfer pricing and to ensure that the examinations are conducted effectively. The following methods could be used:

- Verification of whether or not the gross and operating profit margins of related transactions under the examination are within the range of the profit margins of uncontrolled transactions in the same business category and substantially similar to the related transactions in terms of quantity, market level and other respects; or
- Use of the average value of the consideration or profit margins for related transactions or transactions deemed comparable with the related transactions during a reasonable length of time before and after a taxable year under examination. This may be done if it is considered inappropriate to examine the price of inventory products and other aspects of the related transactions based only on the information for each relevant taxable year, due to considerable fluctuations in prices reflecting changes in public demand, product lifecycle or other such factors.

52. [C.3.5.5.7.3.] Once the transfer pricing audit starts, various aspects of arm's length pricing will be involved and will consume a considerable amount of time. After the above examinations, it may be useful to pause to reflect upon the audit in general. This will occur before starting the calculation of an arm's length value, which will consume the biggest part of the transfer pricing audit resources. The auditor should review whether it is likely that continuing the transfer pricing audit would produce a fruitful result from the viewpoint of efficiency.

C.5.2.5.8. Contemporaneous Documentation

53. [C.3.5.5.8.1.] Contemporaneous documentation is explained in detail in Chapter C.2. The contemporaneous documentation the taxpayer has prepared will be an important document for the examiners, and will be one of the first documents they request.

54. [C.3.5.5.8.2.] The taxpayer is usually required to provide the examiners with the contemporaneous documentation within a specified number of days after a request from the tax authorities. Such documentation should demonstrate that the transfer pricing method and its application provide the most reliable measure of an arm's length price. This represents the first opportunity for the taxpayer to persuade the examiners that the transfer pricing is appropriate. Incomplete or inaccurate contemporaneous documentation may provide the examiners with a "road map" for their transfer pricing audit.

C.5.2.5.9. Information Request/Supplemental Information

55. [C.3.5.5.9.1.] The following is a sample list of information documents required from a corporation engaged in the distribution of products on the assumption that the taxable period under audit is five years. The requested information should be the most up to date unless otherwise required.

- Corporate profile brochure (including the corporate group’s history);
- Organizational chart (setting out the number and names of employees);
- Transactional structure: a business flow chart (invoicing and settlement, and actual delivery flow);
- List of shops: location, size, opening times, sales revenue, staffing, prices, contractual terms with customers (consignment/cash sales etc.) including data on the latest three years for sales, revenue and staffing;
- List of directors;
- Equity relationship structure of group companies;
- Basic business agreements, distribution agreements and other agreements with the related party;
- Corporate profile of the related party;
- Documents related to determination of arm’s length price;
- Transfer pricing method and list of margins by categories of product for five years;
- Latest financial data regarding the sales, cost of goods sold, operating expenses, operating profits and profit before tax for past five years;
- Group global consolidated profit and loss statement and ratio of taxpayer’s sales to group global sales for past five years;
- Segmented profit and loss statements from the related transactions of the related party (if the taxpayer is the purchaser) or the taxpayer (if the taxpayer is the seller) for past five years;
- List of gross and operating profits by category, by product and by distribution channel with detail of losses on disposal of assets and losses from obsolescence for the past five years; and
- Top 10 products in sales by category (name of product, purchase price and retail prices, personnel expenses, advertising expenses and sales promotion expenses) for the past five years.

56. [C.3.5.5.9.2.] As the transfer pricing examination progresses many more questions will arise in the minds of the examiners and, accordingly, many supplemental information requests need to be issued by the examination team. This part of the examination process tends to be necessarily lengthy.

C.5.2.5.10. Request for Interviews

57. [C.3.5.5.10.1.] It is common in a transfer pricing audit for the examination team to request interviews with key company personnel involved in transactions with related parties. The interviews assist the examination team’s functional analysis for purposes of determining the functions performed by the taxpayer and related parties and determining comparability. Transfer pricing economists and the international examiners on the examination team will almost always participate in the interviews, and a lawyer will also be involved. The aspects noted below are pertinent to the taxpayer’s responses to the requests for interviews.

58. [C.3.5.5.10.2.] The examination team will choose the personnel to interview by requesting organization charts. The personnel to be interviewed are decided by the examination team based on mutual discussion of the functions of the personnel in the organization charts.

59. [C.3.5.5.10.3.] The interviewees should be made familiar with the process and should understand the procedures, purpose and importance of the interview.

60. [C.3.5.5.10.4.] Interviews are usually conducted in a cooperative manner. The taxpayer may work with the examination team to agree the rules of the interview by an advance agreement, to avoid confusion. This advance agreement will make it less likely that the taxpayer's efforts will be interpreted as attempts to manipulate the information obtained at the interview. For example, the taxpayer may wish to arrange for the examination team to meet with a group of employees, rather than meet each person separately. In this way the employees have an opportunity to consider the responses of other individuals. On the other hand, the examination team may want to interview each person separately.

61. [C.3.5.5.10.5.] If the person to be interviewed is not a native speaker of the language of the interview it is advisable to use an interpreter even if he/she can speak the language fairly well. The use of an interpreter will avoid the possibility of misunderstanding questions and allow the interviewee time to formulate reasoned responses.

62. [C.3.5.5.10.6.] If an interview is recorded, both parties should keep a copy of the record. It may be useful to have a transcription of the interview record rather than merely an audio recording, considering the possibility and ease of future use. If no recording of an interview is taken the examination team may produce a summary of the interview for the signature of the interviewee. A careful review of the written summary is needed in such event.

C.5.2.5.11. Request to Visit Facilities

63. [C.3.5.5.11.1.] The extent of cooperation for the tax examiners' visit to a taxpayer's facilities will vary from case to case. Representatives of the examination team could be accompanied on the visit by an employee of the taxpayer who can describe the activities at particular locations and respond to questions. This guide should consider the exercise as being similar to an interview or an opportunity to present factual portions of the taxpayer's case as this explanation may affect the taxpayer's position in describing objects or operations on the tour. Ensuring integrity of such contacts with taxpayers is as important here as in other cases of dealing with taxpayers.

C.5.2.5.12. Secret Comparables

64. [C.3.5.5.12.1.] There is an issue concerning secret comparables which often surfaces in connection with transfer pricing audits. Confidential information from other taxpayers may be reviewed for general information or suggestions for further investigation. However, using such information to establish comparables will be a problem. Secret comparables are discussed in detail in paragraph B.2.4.8.

65. [C.3.5.5.12.2.] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations provide, in paragraph 3.36, the following guidance, which should be considered in any application of secret comparables:

“Tax administrators may have information available to them from examinations of other taxpayers or from other sources of information that may not be disclosed to the taxpayer. However, it would be unfair to apply a transfer pricing method on the basis of such data unless the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts.”

**C.5.2.5.13. Attorney-Client Privilege and
Work Product Doctrine**

66. [C.3.5.5.13.1.] The attorney-client privilege and the work product doctrine are well developed in the United States and other countries, although such privilege and doctrine may not be so developed in other countries. The attorney-client privilege protects communications between the client and the attorney or the attorney's agents. Where legal advice is sought from a lawyer in his capacity as such, the communications relating to that purpose made in confidence by the client are protected from disclosure by the client or by the lawyer unless the protection is waived by the client.

67. [C.3.5.5.13.2.] The attorney work product doctrine protects materials prepared for trial or in anticipation of litigation by an attorney or his agent. When litigation is reasonably anticipated in relation to the transfer pricing examination, the due consideration of the attorney-client privilege and the work product doctrine would be important, where they are applicable.

C.5.2.5.14. Comparison Chart

68. [C.3.5.5.14.1.] In the process of examination, it may be useful to prepare a comparison table of the tested party and the comparable. A simple example of a comparison table is shown below.

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**Table C.5.1:
Comparison Chart**

	Tested Corporation	Comparable Corporation
Industry code		
The last day of accounting period		
Contents of business		
Principal products handled		
1. _____(__%)		
2. _____(__%)		
3. _____(__%)		
Principal vendors		
Principal purchasers		
“Home-grown” R&D		
No. of employees		
Territory		
Paid-up capital		
Amount of borrowing		
Sales (five years)		
Gross profits and margins (five years)		
Operating profits and margins (five years)		

Gross profit margins after adjustments		

C.5.3. Narrowing of Issues: Development of Tax Authorities’ Position

C.5.3.1. Refining Understanding of the Taxpayer’s Business

69. [C.3.6.1.1.] During the examination process the examination team needs to review information it has obtained earlier concerning the taxpayer’s business in the light of the taxpayer’s responses to the information requests and other information gathering activities. This will lead to a refined understanding of the taxpayer’s business and such information will affect the choice of comparable transactions or companies.

C.5.3.2. Refining Understanding of the Taxpayer’s Industry

70. [C.3.6.2.1.] Similar efforts will be needed in refining the understanding of the taxpayer’s industry. The examination team will review product line financial statements for multiple years to detect unusual fluctuations or deviations from industry norms that may not result from business cycles or product life cycles.

C.5.3.3. Refining Functional Analysis

71. [C.3.6.3.1.] The examination team will need to understand the functions and risks of the taxpayer and its affiliates before attempting to determine whether particular transactions or companies are comparable to the taxpayer. The examiners will need to identify the functions that are most important in creating value in the taxpayer’s related party transactions. The examiners use information obtained in information requests and interviews to trace the flow of transactions through the taxpayer. They determine who performed significant functions, whether any valuable intangibles were involved and reasons for the transactional structure.

72. [C.3.6.3.2.] The examiners will need to determine the effect of intangible property on the transactions. As higher risk justifies a higher return, the examination team will determine (i) which companies within the group bear market risks (such as fluctuations in cost, demand, pricing and inventory activities), foreign exchange risks (such as fluctuations in foreign currency exchange rates and interest rates), credit and collection risks, product liability risks and general business risks and (ii) whether they receive an appropriate benefit for their contributions.

73. [C.3.6.3.3.] The examiners analyse the economic conditions of the taxpayer's transactions to later identify comparable transactions and companies. The taxpayer will need to participate in this area of the examination to ensure that only appropriate comparables are used. In summary, refining functional and risk analysis is important in reaching the correct results of arm's length transactions. See further Chapters B.2. and B.3.

C.5.3.4. Choice of Transfer Pricing Method

74. [C.3.6.4.1.] After refining the functional and risk analysis, the examination team will choose the transfer pricing method in the light of that analysis. See further Chapter B.3. on the selection of an appropriate method.

C.5.3.5. Economist's Report or Examiners' Interim Opinion

75. [C.3.6.5.1.] Toward the end of the examination procedure, the examination team often produces a written economist's report or examiners' interim opinion; unless the examiners judge that no adjustment should be made. It is often helpful to resolve factual issues important to the analysis or agree to disagree on certain issues while the information is fresh rather than delaying the resolution until the end of the examination process. This will help to narrow the scope of any points of disagreement as much as possible.

76. [C.3.6.5.2.] The taxpayer has significant flexibility at this stage. It may refuse and disagree with the report or opinion, accept or suggest modifications.

C.5.3.6. Draft Proposed Adjustments

77. [C.3.6.6.1.] When the examination team considers that it sufficiently understands the transfer pricing issues and has concluded discussions with the taxpayer, it will produce the draft proposed adjustments, if any.

78. [C.3.6.6.2.] In some countries, the proposed adjustments may be combined with the examiners' interim report described above, depending on the circumstances.

79. [C.3.6.6.3.] This will be the last chance for the taxpayer to determine whether or not to reach a settlement with the examination team.

C.5.3.7. Formal Notification to Taxpayer of Proposed Adjustment

80. [C.3.6.7.1.] Unless the taxpayer and the examination team can reach agreement, the formal notification of the proposed adjustment will be issued.

81. [C.3.6.7.2.] In some countries, the issuance of a formal notification of proposed adjustment is statutorily required for the issuance of the adjustment order—in which event the taxpayer is given the opportunity to accept the notification within a stipulated time (for instance, 30 days) and/or notify any set-offs. In other countries this formal notification procedure does not exist.

C.5.3.8. Issuance of Adjustment/Correction

82. [C.3.6.8.1.] If the taxpayer does not accept the formal notification of proposed adjustment, a final adjustment (i.e. a notice of deficiency) will be issued. In certain countries this final notice of correction will be issued without going through the formal notice of proposed adjustment.

C.5.3.9. Settlement Opportunities

83. [C.3.6.9.1.] There should be the opportunity for settlement with the examination team throughout the process of the transfer pricing examination. Proper transfer pricing planning and documentation and active involvement in the examination process may facilitate a settlement with the examination team.

84. [C.3.6.9.2.] If a settlement cannot be achieved with the examination team, it may be achieved with the administrative appeals officer. Depending on the circumstances of a case, settlement may vary greatly taking into account time and other resources that may be saved by avoiding a lengthy legal dispute.

85. [C.3.6.9.3.] Settlement processes may be explicitly provided for in the transfer pricing rules, or applied through a broader system of tax dispute settlement. The Mutual Agreement Procedure and other aspects of dispute settlement are addressed in Chapter C.4. of this Manual.

C.5.4. Case Closure

86. [C.3.7.1.] The case closure needs to be properly documented, as every decision taken can potentially be subject to litigation. The table below provides a clear documentation process to ensure the information needed is recorded and to guarantee that the required process has been followed. The audit report is also captured in the table with all the required details.

C.5.5. Relationship between Transfer Pricing Audits and Advance Pricing Agreements

87. [C.3.8.1.] The merit of Advance Pricing Agreements (APAs) is that once an APA is agreed upon the pricing in accordance with the terms of the APA will not be disturbed by a transfer pricing examination. However, there is a subtle relationship between an APA and a transfer pricing audit. There is a risk that information submitted to the tax authorities for the purposes of the APA may be used for the purposes of the transfer pricing audit. Also, while an APA application is being pursued a transfer pricing audit may be conducted before the APA is finalized.

88. [C.3.8.2.] As an example, the following measures are taken in Japan to protect a taxpayer's pursuit of an APA:

- In order to ensure confidence in the APA system, documents (other than factual documents such as financial statements, capital relationship diagrams and summary statements of business) received from a taxpayer for an APA review may not be used for a tax examination;
- While an APA is in progress a tax examination on transfer pricing aspects will not be conducted for the years to be covered by the APA application (including the roll-back years).

This may require an agreement to extend or otherwise modify the statute of limitations, if such agreements are permitted under local law, so that the processing of an APA application will not compromise the tax authority's ability to propose audit adjustments if the APA process ultimately fails to lead to an agreement.

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Table C.5.2: Audit Closure Template

AUDIT TEAM:		DATE:
TAXPAYER NAME:	TIN:	
	TAX PERIOD:	
PHYSICAL ADDRESS:	AUDIT TYPE:	
DATE OF COMMENCEMENT:	DATE OF COMPLETION:	

TAXPAYER'S NATURE OF BUSINESS & MAIN ACTIVITIES:

MEMBERS OF AUDIT TEAM			
NAME	DESIGNATION	EMPLOYEE ID. NO.	
1			
2			
3			
4			
5			

TAX TYPES COVERED	TAX PERIODS AUDITED

1. AUDIT OBJECTIVE

2. AUDIT SCOPE

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3. RISKS IDENTIFIED AT PROFILING AND PLANNING STAGE

4. RISKS IDENTIFIED DURING AUDIT EXECUTION

5. RECORDS REVIEWED AND AUDIT METHODOLOGY USED (work done)	Cross reference to working papers
<input type="checkbox"/> <input type="checkbox"/>	

6. AUDIT FINDINGS i.e. observations on compliance (accuracy, completeness and validity)	
<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>	

7. SUMMARY OF REVISED ADJUSTMENTS/ASSESSMENTS AND TAX PAYABLE						
TAX TYPE	PERIOD AUDITED	REVISED TAX	PENALTY	INTEREST	TAX PAID	TAX DUE

7A. SUMMARY OF LOSSES CARRIED FORWARD/ UNABSORBED CAPITAL ALLOWANCES RELIEVED		
YEAR	LOSS C/F RELIEVED	UNABSORBED C/A RELIEVED
2011		
2012		
2013		
2014		
2015		
2016		

8. TAXPAYER'S BANK ACCOUNT(S) DETAILS	
BANK NAME	ACCOUNT NUMBER

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9. TAXPAYER CONCURRENCE, RECOMMENDATIONS, OR COMMENDATIONS

10. INTERNAL RECOMMENDATIONS (exclude from the taxpayer's copy of audit report)

11. CHALLENGES ENCOUNTERED AND LIMITATIONS TO THE AUDIT

12. OBSERVATIONS BY LEVEL SUPERVISOR
Name, Signature and Date

13. OBSERVATIONS BY TEAM LEADER			

14. ENDORSEMENT BY MEMBERS OF THE TEAM			
NAME	DESIGNATION	SIGNATURE	DATE