
**Committee of Experts on International
Cooperation in Tax Matters
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**Update of the United Nations Practical Manual on Transfer Pricing for Developing
Countries**

Co-coordinator's 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 B); and
- Revised text on Establishing Transfer Pricing Capability, Risk Assessment and Transfer Pricing Audits (Attachment C).

I. BACKGROUND

1. 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:
3. 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.
4. 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.
5. 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 twenty-second session in 2021 and preferably in 2020.

III. THE CURRENT SUBCOMMITTEE'S WORK

6. 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.
7. 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.
8. 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.
9. 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, particularly on the following topics where texts are now presented to the committee for first discussion and guidance during the 18th session, as follows:
 - **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) analyse 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 Subcommittee has not yet discussed any of the examples in shaded text and comments are therefore not invited for discussion at this Session of the Committee.

- **Attachment B:** Revision to the guidance contained in the Manual on the transactional profit-split method (Chapter B.3.3.) with the main 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. Shaded text, such as on the use of “hindsight”, will need further Subcommittee discussion before a draft is ready for Committee consideration and comments are therefore not invited for discussion at this Session of the Committee.
- **Attachment C:** A progress 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.

IV. NEXT SUBCOMMITTEE MEETING

10. The subcommittee will hold a meeting in Amsterdam on July 2-4, 2019 hosted by the Netherlands Ministry of Finance and the IBFD. The meeting will aim to further progress the update, including addressing any issues raised by the Committee at the 18th Session, with a view to finalizing the work represented by Attachments A to C at the 19th Session to the extent that further discussion of these parts is considered necessary. There will also be further work to ensure that a revised chapter B.2 of the Manual dealing with comparability analysis, including further examples and suggestions to address the lack of comparables, is ready for a first consideration by the Committee at its 19th session. A main purpose of this update on comparability is to seek consistency between the Manual and the Platform for Collaboration on Tax Toolkit on Comparability and, where useful, adding references to draw upon the practical guidance in the latter. Other texts will also be presented to the Committee at the 19th session for further consideration.

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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. Reference can be made to the cash pooling example mentioned in B.9.1.4.5. supra.

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

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,

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:

- 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.

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. Separate and apart from the BEPS Action 4 proposals referenced in B.9.1.4., 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 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 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.

- (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; and
 - (g) convertibility of the funding (for example 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.9.2.1.3. 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. Examples of the analysis of financial transactions are provided in paragraph B.9.3.2.2. infra.

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

NB: The text of this part of the Chapter has not yet been reviewed in a Subcommittee meeting although comments from individual subcommittee members have been considered and included.

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 needs 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 explicit or implicit collateral the borrower can offer) and consideration of future cashflows 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. Commercially, credit risk may be measured by assigning a rating (i.e. credit rating) to the tested party. The rating expresses the probability of default. Some MNEs have developed inhouse 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 in inhouse commercial tools may mostly consider quantitative factors and not necessarily qualitative factors such as industry, 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 of an entity’s probability of default. Although credit ratings are important and useful, they may not be 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	Interpretations ⁷
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+	
A2	A	A	

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.

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A3	A-	A-	Strong payment capacity; more likely to be affected by changes in economic circumstances.
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. Nevertheless, credit rating opinions are usually issued upon request only for the parent company of the group. However, the assessment of the arm's length nature of the financial transaction under review would generally commence with the requirement that the associated enterprise be considered as independent of its counterpart and that its credit risk be determined consistently with this principle. Therefore, in order to assess the stand-alone credit rating of a group entity in relationship to the transaction under review, other instruments can be used in practice, e.g. the following:

- Beginning with the parent's credit risk, adjust this credit risk (if required) to approximate the associated enterprise/debtor's credit risk;
- Derive the associate enterprise/debtor's credit risk with an analysis of the financial ratios (for example, look at what the income flow is of the debtor and what assets it has available to serve as collateral for the intra-group debt, to determine if debt issued by an associated enterprise can be serviced by the debtor);
- Derive the associated enterprise/debtor's credit risk by using credit scoring tools.

Subsequently to the above determination, the impact of implicit support or passive association may need to be considered.

B.9.2.2.4. When establishing the credit risk of the associated enterprise, some important questions should initially be answered.

B.9.2.2.5. The first of these questions is whether the credit rating of the associated enterprise/debtor should be established considering its economic and financial characteristics before the financial transaction under review is put in place or considering how the situation would be afterwards. In most of the cases, the situation that would be in place after the new financing transaction takes place has to be considered. In addition, it may be worthwhile to consider that the company's economic and financial characteristics that are reviewed for credit rating purposes, may be influenced by any intercompany transactions it has, i.e. transfer pricing.

B.9.2.2.6. The second question is whether the credit rating of the associated enterprise/debtor should be assessed on a completely stand-alone basis (referred to as the 'stand-alone credit rating') or considering that the associated enterprise/debtor belongs to a group (known as the 'group credit rating') and taking into account, therefore, any 'implicit support' from the MNE group in which the tested party belongs (sometimes also referred to as 'passive association', 'parent support', or 'group support').

B.9.2.2.7. 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 in otherwise the same circumstances. However, "the same circumstances" must include any incidental benefits and group synergies deriving from the circumstance that the related entities belong to an MNE group (i.e. includes the impact of implicit support, if any).

B.9.2.2.8. 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.9.2.2.9. To answer the questions posed above, it might be relevant to consider the following elements:

- To what extent (if any) would implicit support be taken into account by independent institutions (e.g., independent credit agencies or independent commercial banks) when assessing the credit risk of the associated enterprise that is the borrower?
- Essentially, only the MNE Group will 'know' if there will be support when that support will be needed;
- If implicit support is considered by independent institutions, how would the implicit support be quantified?

B.9.2.2.10. In practice, the answers to these questions will highly depend on the level of strategic importance that the associated enterprise has in the group. One way that strategic importance and implicit support could be quantified is by considering the strategic importance of a specific entity as follows:⁸

⁸ 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.

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>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>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. Determining the presence of an implicit guarantee and quantifying the impact thereof may be very complicated and subject to different interpretations.

B.9.2.2.11. It is important to mention that, although implicit support is often associated with a higher credit rating for the associated enterprise, it might also be the case that the associated enterprise's credit rating is negatively influenced by the MNE group's credit risk (i.e. as a result of negative synergies). In addition, it may be relevant to note that it is also common to consider the market 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) and that in 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.9.3.1.⁹

B.9.2.3. Considering the creditworthiness of the financial instrument

B.9.2.3.1. The credit rating of the debtor tends to be the first credit 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

⁹ For further 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 Petruzzi.

essence is lower than that of the other three loans. This “status” is generally expressed as the “issuance” credit rating. The credit rating of a specific financial instrument is linked to the specific features of that 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 (issuance rating) is generally notched down from the credit rating of the borrower (issuer 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.

B.9.2.4. Potential Transfer Pricing Methods

B.9.2.4.1. With respect to various intra-group financial transactions (e.g. loans and financial guarantees), 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. For these services, the cost-plus method or cost-based TNMM can be utilized (or in certain circumstances, 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 (i.e. global trading).

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.¹⁰

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, until and unless there is clear evidence that using that rating would be distortive. This approach has the added benefits of providing certainty and reduction in administrative burden to both tax administrations and taxpayers. It is important to note that this guidance only presents a particular approach to eliminating the effect of special conditions on the profits of related enterprises and that it only applies in the context of pricing the specific financial transactions.

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. It has been observed that MNEs make sure they fall within the simplification rules or safe harbours that are available where perhaps an arm's length approach would have generated more (taxable) revenue for the jurisdiction involved. 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.

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. 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 need to be compensated for the liquidity provided and the risk taken on by an arm's length payment, i.e., an interest payment. All relevant terms and conditions of the loan should

¹⁰ As an example, some countries (i.e. Singapore, Serbia) provide 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. 10.000.000 Euro or equivalent) 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.

be 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 repayment schedule¹¹, and a maturity ranging from 1 to 10+ years that is generally 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.

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 paragraph 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., type of loan, tenure – i.e., time to maturity – of the loan, obligation to pay and type of interest rate (contingent on profits or other?), currency used, embedded options, seniority of the loan, subordination of the creditor, collateral, security and guarantees, repayment schedule (fixed, contingent or other?)). In some cases, certain relevant characteristics may not be included in the contractual

¹¹ 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.

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 an assessment of the debt capacity and credit risk of the borrower.
- 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.
- In addition, the conduct of the parties with respect to the conditions of the financial relation merits review.

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.

NB: The Examples below (in shaded font) are still under consideration in the Subcommittee. Committee guidance on them will be sought at a later stage

Example 1: accurate delineation of the actual transaction

ACo, located in Country X (local currency XCU), is an associated enterprise of BCo, located in Country Y (local currency YCU). ACo and BCo conclude an intra-group loan agreement whereby ACo will provide BCo with 1 million XCU. BCo will pay ACo an annual fixed interest of 3% for the intra group loan.

Based on the terms of the intra group loan, the foreign exchange risk of the transaction is for the account of BCo. This means that if the YCU currency devaluates against the XCU, BCo's debt as expressed in its local currency of YCUs against XCUs for all practical purposes increases. However, upon accurate delineation, it becomes clear that BCo does not manage the FX risk and has no financial capacity (or FX hedging capacity) to assume this risk. ACo, on the other hand can manage this risk and has the financial capacity to assume this risk as it has a department that is engaged in FX hedging.

Considering the above findings, it merits analysis why BCo is allocated the FX risk under the terms of the intra group loan. Accurate delineation of the actual transaction might potentially result in the attribution of any future FX gains or losses deriving from materialization of the foreign exchange risk to ACo.

Example 2: accurate delineation of the actual transaction

ACo, located in Country X, is an associated enterprise of BCo, located in Country Y. In order to develop a new business idea, BCo asks ACo (who has available financial resources that it does not need for its own business development) to provide an intra-group loan.

Based on the terms and conditions of the intra-group loan as accurately delineated, maturity of the loan is indefinite and BCo is obliged to pay interest expenses only in some circumstances (e.g. during years it is profitable and after payment of interest on all other existing loans, i.e. the loan is subordinated, and interest payments are dependent on profit).

The concepts of interest payments being dependent on profitability (profit-sharing) and being subordinated to payments to other creditors resemble how equity investments are treated. Shareholders tend to get dividend only when there is enough profit available for dividend distributions. Therefore, based on the law in country Y, the tax authorities of country Y might not recognize the actual transaction as described in the contract between ACo and BCo. Although the decision between provision of loan or equity is a business decision of the group, the characteristics of the intra-group loan as accurately delineated would make the transaction more resemble an equity contribution than the provision of debt financing. Indeed, BCo might not have obtained debt financing under the same terms and conditions from a third-party lender or, if obtained, the interest rate applied may have been too high to be accepted by BCo.

Example 3: accurate delineation of an intra-group loan

ACo, located in Country X, is an associated enterprise of BCo, located in Country Y. ACo and BCo conclude an intra-group loan agreement whereby ACo will provide financial resources to BCo.

One of the conditions of the intra-group loan agreement is the possibility by BCo, to repay the loan at any time. No extra-charge would be applied by ACo in case of early repayment of the loan by BCo.

The arm's length pricing of the intra-group loan might require the application of a higher interest rate to consider the additional risks for ACo deriving from the option of early repayment. A third-party lender would have most probably applied a fee (or a higher interest rate) to consider this option.

Example 4: accurate delineation of an intra-group loan

ACo, located in Country X, is a related-party of BCo, located in Country Y. ACo and BCo conclude an intra-group loan agreement whereby ACo will provide financial resources to BCo.

One of the conditions of the intra-group loan agreement is the possibility, by BCo, to early repay the loan at any time. Different from example 3 above, in this example, if BCo wishes to exercise this option, BCo must pay to ACo all the interest payments that it should have been paying in the future for the term of the loan, but now at the time of early repayment.

Despite the right for early repayment, the arm's length pricing of the intra-group loan in this case might not require the application of a higher interest rate to consider additional risks for ACo deriving from the option of early repayment.

Example 5: accurate delineation of an intra-group loan

ACo, located in Country X, is a related-party of BCo, located in Country Y. To develop a new business idea, BCo asks ACo (who has available financial resources that it does not need for its own business development) to provide an intra-group loan. Upon review it appears that BCo is in a strong economic and financial situation (both before and after the new intra-group loan) and does

not really seem to need the new financial resources, since it has enough financial resources of its own.

The strong economic and financial situation of BCo most likely means that BCo could have obtained the same debt financing from a third-party lender. The tax authorities of Country Y might consider this aspect and accept the intra-group loan as delineated by ACo and BCo considering that BCo would probably have been able to obtain an (similar) external loan from third parties based on its own debt capacity. The decision between intercompany provision of a loan or equity is a business decision of the group.

Example 6: accurate delineation of an intra-group loan

ACo, located in Country X, is a related-party of BCo, located in Country Y. To develop a new business idea, BCo asks ACo (who has available financial resources that it does not need for its own business development) to provide an intra-group loan. Upon review it becomes clear that BCo, after the new intra-group loan, would be in a very weak economic and financial situation.

BCo might not have obtained the same debt financing from a third-party lender or, if obtained, the interest rate applied would have been too high to be accepted by BCo. The tax authorities of Country Y might consider this aspect and not accept the actual intra-group loan as delineated by ACo and BCo. Although the decision between provision of loan or equity is a business decision of the group, the very weak economic and financial situation of BCo would make debt financing not a commercially rational decision for a third-party lender.

B.9.3.2.4. 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.9.3.2.5. 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: research of interest rates applied to similar transactions in similar circumstances between one of the tested parties and an unrelated entity.
- External CUP method: either research of 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 commodities approach: application thereof or of a version of the sixth method (see B.9.3.2.10.).

Example 7: the internal CUP method

ACo, located in Country X, is a related-party of BCo, located in Country Y. ACo and BCo conclude an intra-group loan agreement whereby ACo will provide financial resources to BCo.

BCo also receives financial resources from a third-party lender, with the same conditions as the ones agreed with ACo. If the two loans are comparable (i.e. considering all the economically relevant characteristics, terms and conditions), ACo and BCo could consider using the interest rate applied to BCo by the third-party lender to identify the arm's length intra-group interest rate. However, it should be noted that if the impact of the second loan (to the third-party lender) is such that the credit rating of BCo would be relevantly reduced, the interest rate of the second loan may not present a proper internal CUP.

Example 8: the external CUP method

ACo, located in Country X, is a related-party of BCo, located in Country Y. ACo and BCo conclude an intra-group loan agreement whereby ACo will provide financial resources to BCo.

Publicly available information is available on the terms and conditions applied between third-parties on comparable loans (i.e. considering all the economically relevant characteristics).

ACo and BCo could use the interest rates applied in the third-party comparable loans in order to identify the arm's length intra-group interest rate.

Example 9: the alternative external CUP method

ACo, located in Country X, is a related-party of BCo, located in Country Y. ACo and BCo conclude an intra-group loan agreement whereby ACo will provide financial resources to BCo.

An arm's length interest rate can also be based on the return of realistic alternative transactions with comparable economic characteristics. Depending on the facts and circumstances, realistic alternatives to intra group loans could be, for instance, bond issuances.¹²

Publicly available information is available on the terms and conditions applied between third-parties on comparable bonds (i.e. considering all the economically relevant characteristics).

ACo and BCo could use the interest rates applied in the third-party comparable bonds in order to identify the arm's length intra-group interest rate.

Example 10: simplification measure

ACo, located in Country X, is a related-party of BCo, located in Country Y. ACo and BCo conclude an intra-group loan agreement whereby ACo will provide financial resources to BCo.

BCo's standalone creditworthiness and credit rating is not known or currently available. The ACo Group rating however, is known and is BBB.

Based on information available from public sources, third-party comparable bonds (i.e. considering all the economically relevant characteristics, including the BBB rating of the ACo Group are made available with an interest rate between 4% and 6%.

If the Country Y tax authorities accept the simplification measure that for purposes of accurate delineation, the ACo Group credit rating may be used instead of the BCo standalone credit rating, in analyzing the arm's length fee for the intercompany loan, an interest rate between 4% and 6% for the intercompany financing will be acceptable as arm's length.

¹² See also paragraph 86 of the OECD Discussion Draft on Financial Transactions.

B.9.3.2.6. 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 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.

B.9.3.2.7. 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.

B.9.3.2.8. 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. 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.9.3.2.9. Some countries apply a rule for determining the interest rate for loans using the same approach used for commodities, also referenced as “sixth method” (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 advantage of this approach is the same as the sixth method rule for commodities, that’s to say it eliminates the need for a comparable transaction.¹⁵ The sixth method rule is discussed in Chapter B.3.4.2.

B.9.3.2.10. Other methods used for 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 and obtaining written opinions from independent banks. These methods are not discussed in detail in this chapter, however.

B.9.3.2.11. 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

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

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.

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-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. Example 11 below elaborates on this situation.

Example 11

Company A, a limited risk distributor in Country A and a member of MNE Group ABC, buys products from Company B, a related party producer in Country B. It markets those products in Country A and sells them to unrelated wholesalers and large retailers. Some of its largest customers are themselves part of an international business with which MNE Group ABC does business in several countries. There are seasonal peaks for sales during the year.

Company A uses a TNMM as the most appropriate method to benchmark its distribution activities and to determine its compliance with transfer pricing rules. It uses the profit level indicator of operating profit (profit before interest and tax) to sales. It produces benchmarking studies in accordance with best practice that demonstrate comparable companies achieve profit margins of 1%-3%, based on the interquartile range of results. These margins reflect the result of working capital adjustments based on year end balances to improve reliability of the comparisons. The company's results over the past three years have been around 2% in each year (and thus within the 1% - 3% range).

In Year 4 the results of the distributor continued to show operating profit margin of 2% but its accounts include a significant increase in interest costs. These costs resulted in no profits being reported after interest.

In its transfer pricing documentation for Year 4 Company A explained that the interest related to a loan from Company C, an associated enterprise in Country C. Company A provided a report demonstrating that it had a high credit rating and that the interest rate charged was in line with interest rates charged to independent parties with similar credit rating.

Upon review of the tax return of Company A for Year 4, the tax inspector was concerned about the intra-group interest costs which eliminated taxable profits.

The tax inspector decided that further information about the loan was needed, and in particular, information was needed on the purpose of the loan in the context of the business of the distributor. The taxpayer provided the terms of the funding and explained that the interest costs related to drawing down on an arrangement with associated enterprise Company C that provided short-term

funding to meet its working capital requirements. This response provided insufficient detail about the purpose of the intra-group loan. A distributor generally tries to reduce its working capital requirements by minimising inventory levels compatible with commercial objectives and by seeking better payment terms from suppliers than it grants to customers. Further enquiries by the tax inspector established that the distributor had extended credit terms to its customers from 30 days to 180 days, without changing prices for its customers, but it continued to pay its related party supplier within 7-30 days in accordance with the Group's centralised payment processing cycle. The changes responded in part to demands from the head offices of large (unrelated) international retailers who wished to expand their business with MNE Group ABC and standardise terms globally; and in part to enable smaller retailers in Country A to stock and display an extended range of products to stimulate demand. Most of the sales made by Company A occurred in the second and third quarter of the accounting period; the build-up of accounts receivable during these quarters caused the pressure on cashflow which was relieved by the funding from associated enterprise Company C.

Therefore, it could be concluded that the main purpose of the intragroup funding was to finance the cost of extending more favourable credit terms to its customers. In effect, Company A provides an incentive to its customers by taking on some of their working capital funding costs. Unlike other kinds of sales incentives, however, the costs incurred by Company A (as associated enterprise interest expenses) are recorded for accounting purposes below the operating profit line.

At this point the tax inspector is likely to be able to accurately delineate the funding arrangement, including its purpose in the context of the business.

The initial view of the tax inspector was that Company A should have negotiated better payment terms from its supplier, associated enterprise Company B, so that interest costs were reduced or eliminated. The tax inspector also felt that if an incentive other than involving interest costs had been provided, then the costs would have been recorded in arriving at operating profit. As a result, the costs of the incentive would have been effectively passed to associate enterprise Company B by maintaining the 2% operating profit margin supported by the benchmarking exercise.

However, the tax inspector understood that the transfer pricing rules do not endorse second-guessing the behaviour of the taxpayer or postulating different transactions; instead they authorise evaluation of the actual transaction.

The tax inspector concluded that there was no reason to question the arm's length pricing of the funding arrangements considered in isolation. However, the funding pointed to an aspect of comparability since the circumstances of Company A had changed when it extended its credit terms. What needed to be examined was whether the TNMM benchmarking continued to be reliable in the light of a change in circumstances. Routine working capital adjustments had failed to pick up the impact of increased accounts receivables because the year-end balance was low; the additional working capital requirements spiked in the second and third quarter of the accounting period. It is not ascertainable from the accounts of the comparable companies used in the benchmarking analysis whether they also experienced similar spikes in working capital. One option could be to assume that the comparable companies did not experience similar spikes in working capital, and to simply increase the operating margin of the comparables by reference to the additional interest costs of Company A. However, that option depends on an assumption that has no evidentiary support and would likely be unreliable. A better option is to assume that the comparables will run their business to maximise profit opportunities and in doing so will make commercial decisions about incentives, credit terms and funding costs. The choices made might or might not affect operating profits, depending on the accounting classification of the costs, with

the result that comparison at the level of operating profits could be unreliable. However, the various choices made will all impact on profit after interest.

The tax inspector examined the comparables in the taxpayer's benchmarking analysis but used the ratio of profit before tax to sales as the profit level indicator. By so doing interest costs were included in the comparison. This changed the profit margins of some of the comparable companies but made minimal difference to the interquartile range of profit margins; the margins based on profit before tax continued to show a range of 1-3%.

The tax inspector concluded therefore, that Company A should report profits before tax within this range. The tax inspector did not disallow the interest costs, since the funding arrangements in isolation are priced in accordance with the arm's length principle. However, the tax inspector concluded that pricing adjustments should be made so that the taxpayer continued to report profits at the same level as those reported by comparable, uncontrolled parties. The pricing adjustment is made against the cost of goods supplied by Company B not against the interest charged by Company C.

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 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 confirmation to that extent from the parent company or the borrower. 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 is non-explicit, meaning that there is 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 to assess the extent to which there is implicit support, if any. Furthermore, it should be considered what the impact is of the implicit support, considering that implicit support usually has the result of reducing the cost of financing for the borrower vis-à-vis the lender. 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.

However, to the extent that the financial guarantee increases the amount that can be borrowed (i.e. increases debt capacity of the borrower), it may be considered whether a portion of the loan from the lender to the borrower, when accurately delineated, ought to be considered to be a loan from the lender to the guarantor, followed by an equity contribution from the guarantor to the borrower. If that were to be the accurate delineation, only the guarantee relating to the portion of the funding which can be regarded as a loan to the guaranteed borrower would need to be priced.

B.9.4.2.5. On the contrary, an intra-group financial guarantee will 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 may be considered merely a shareholder service.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).

Example 12: accurate delineation of an intra-group financial guarantee

ACo, located in Country X, is a related-party of BCo, located in Country Y. BCo has requested a loan from a third-party lender. ACo has provided an intra-group financial guarantee for this loan.

Based on the conditions of the intra-group financial guarantee, ACo will cover the amount of principal and interest payments due by BCo to the third-party lender in case of default by BCo. However, based on the analysis of the economic and financial situation of BCo, it appears that BCo will be able to cover only the interest payments as it does not have sufficient current or foreseeable cash flow or available collateral to repay the principal. Therefore, ACo essentially will be obligated to repay the principal.

The accurate delineation of the intra-group loan should consider this circumstance before an arm's length fee can be determined for the guarantee to be paid by BCo to ACo.

Example 13: accurate delineation of an intra-group financial guarantee

ACo, located in Country X, is a related-party of BCo, located in Country Y. BCo has requested a loan from a third-party lender. ACo has provided an intra-group financial guarantee for this loan, for which BCo is charged a fee.

Assume that ACo's creditworthiness and credit rating is A. BCo's creditworthiness (after considering the effect of implicit support) and credit rating is determined to be BBB. Upon closer review it becomes clear that the interest rate applied by the third-party lender corresponds to loans provided to an A credit rating.

Based on accurate delineation, the ACo guarantee has provided benefit for BCo, as the third-party lender charges interest on the loan to BCo based on the A rating. For practical purposes, in this example it can be further assumed that the arm's length fee for the financial guarantee was calculated by using the cost benefit approach further elaborated in example 17 below. The tax authorities of Country Y accept the fee BCo pays for the intra-group financial guarantee.

Example 14: non-recognition of intra-group financial guarantee

ACo, located in Country X, is the parent company of BCo, located in Country Y. BCo has requested a loan from a third-party lender. ACo has provided an intra-group financial guarantee for this loan.

¹⁸ Alternatively, 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.

It has been established that due to the very weak economic and financial situation of BCo, the latter would not have been able to obtain the third-party loan in the absence of the explicit intra-group financial guarantee from ACo.

Based on an accurate delineation, the tax authorities of Country Y question if the fee BCo pays for the guarantee to ACo is at arm's length. Considering BCo's very weak economic and financial situation, BCo would not have obtained the same financial guarantee from a third-party insurance company, or if a financial guarantee could possibly have been obtained, the guarantee fee applied would have been so high that it would be commercially irrational for BCo to enter into that transaction. Therefore, the tax authorities of Country Y recharacterize the guarantee fee and consider the explicit financial guarantee a shareholder service by ACo.

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 can 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, 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: research of (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.

Example 15: the internal CUP method

ACo, located in Country X, is a related-party of BCo, located in Country Y. BCo has requested a loan from a third-party lender. ACo has provided an intra-group financial guarantee for this loan.

BCo also receives a guarantee on the same loan from a third-party insurance company, under the same conditions as the ones agreed with ACo. Assuming that the intra-group financial guarantee and the third-party insurance are comparable (i.e. considering all the economically relevant characteristics, including BCo's membership of the ACo-BCo group and therefore the impact of implicit support for both entities that provide a financial guarantee, if any), ACo and BCo could use the premium applied to BCo by the third-party insurance in order to identify the arm's length intra-group guarantee fee.

Example 16: the external CUP method

ACo, located in Country X, is a related-party of BCo, located in Country Y. BCo has requested a loan from a third-party lender. ACo has provided an intra-group financial guarantee for this loan.

Publicly available information is available on the terms and conditions applied between third-parties on comparable financial guarantee (i.e. considering all the economically relevant characteristics).

ACo and BCo could use the guarantee fee applied in the third-parties comparable financial guarantee to identify the arm's length intra-group guarantee fee.

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.

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 payable with the guarantee in place. To determine the benefit, first of all the interest cost are calculated for the borrower as if it were to take on the financial instrument on its own merit (but with inclusion of implicit support). So, an estimation is made of the stand-alone credit rating after which follows notching that credit rating for the effect of the parent-subsidiary relationship. Next, the interest rate due based on the credit rating of the guarantor is calculated by looking at the spread in corporate bond yields between the parent's credit rating and the estimated credit rating of the subsidiary. 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 cost benefit approach or Interest Savings approach), is accepted by various taxing authorities and judicial bodies globally.
- 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 calculated 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; and through (v) Letter of credit and commitment fees: the arm's length amount of the guarantee fees

will be determined by referencing the third-party letter of credit fees and third-party commitment fees.

Example 17: the cost approach and yield approach

ACo, located in Country X, is a related-party of BCo, located in Country Y.

BCo has requested a loan from a third-party lender.

ACo has provided an intra-group financial guarantee for this loan.

ACo's credit rating is A, while BCo's credit rating is BBB.

BCo's expected 1-year probability of default rate¹⁹ is 0.12% and its expected recovery rate²⁰ (considering its fixed assets and securities) is 40%.

The cost approach quantifies the additional risk borne by the guarantor ACo by estimating the value of the expected loss that ACo may incur because of providing the guarantee in case BCo defaults (expected loss in case of default by BCo). Then the expected cost of providing this guarantee is 0.07% (calculated as follows: $0.12\% * (1 - 40\%)$).

The third-party lender has provided the loan to BCo at an interest rate of 3%.

Based on information available from public sources, third-party comparable bonds (i.e. considering all the economically relevant characteristics, including the BBB rating of the issuer) have a rate of 4%.

Under the yield approach, the interest benefits received by BCo for such intra-group financial guarantee (i.e. its reduced cost for the funding) would be of 1% (i.e. 4% - 3%).

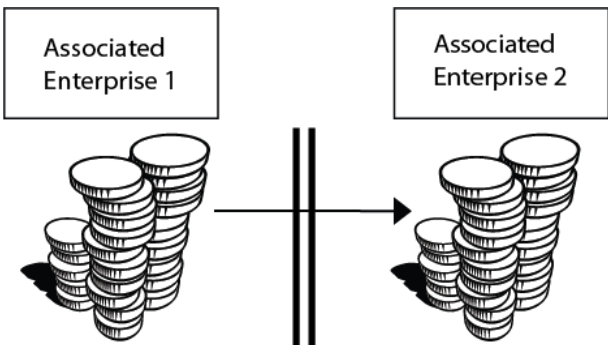
Therefore, the arm's length range of intra-group guarantee fees falls between 0.07% (cost approach) and 1% (yield approach) and the arm's length fee will be higher than 0.07%. and lower than 1%, depending on the bargaining between ACo (the guarantor) and BCo (the borrowing entity)

¹⁹ Probability of default is a financial term describing the likelihood of a default over a particular time horizon. It provides an estimate of the likelihood that a borrower will be unable to meet its debt obligations

²⁰ Recovery rate is the extent to which principal and accrued interest on defaulted debt can be recovered, expressed as a percentage of face value.

REVISED TEXT ON PROFIT SPLIT:

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. [No change]</p>
<p>Figure B.3.5: Profit Split Method</p>  <p>The diagram illustrates the Profit Split Method. It shows two boxes, one for 'Associated Enterprise 1' and one for 'Associated Enterprise 2'. Below each box is a stack of coins. An arrow points from the stack of coins under Enterprise 1 to the stack of coins under Enterprise 2, indicating the flow of profit from Enterprise 1 to Enterprise 2.</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</p>	<p>3. The profit split method is <u>may be</u> likely to be the most appropriate method in cases where:</p> <ul style="list-style-type: none"> • each related party to the transaction makes unique and valuable contributions; and/or

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<p>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 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.</p>	<ul style="list-style-type: none">• the business operations of the related parties are so highly integrated that they cannot be reliably evaluated in isolation from each other; and/or• <u>the parties share the assumption of economically significantly risk or separately assume the assumption of closely related risks.</u> See paragraph 8 et seq. <p>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, therefore, the split should reflect the relative value of each enterprise's contribution, including its functions performed, risks assumed and assets used or contributed.</p> <p>5. The profit split method is also referred to as the transactional profit split method. It can be in order to better distinguished it 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.</p>
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B.3.3.14. Methods to Allocate or Split the Profits [MOVED BELOW]

B.3.3.15 Comparable Profit Split Method [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 (uniquely among commonly used transfer pricing methods) with returns to synergies between contributions intangibles 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 	<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>and tax administrations may have difficulty 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

[MOVED BELOW]

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.

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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~~of first resort.~~

~~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 ~~(i.e. typically relatively less complex or routine or benchmarkable activities), and without reference to the contributions of the other party,~~ a profit split is unlikely to be the most appropriate method ~~(unless the integration between the parties means that the value of the contributions of the parties are significantly affected by that integration.~~ In such cases, it is likely to be more reliable to apply ~~another~~ transfer pricing method making use of the uncontrolled comparables, even in cases where ‘perfect’ or closely comparable uncontrolled transactions are ~~information is~~ lacking. See [insert cross reference to lack of comparables.]

~~14.~~

~~15.~~ 13. 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. ~~As noted above, where comparables are indeed available to reliably benchmark an arm’s length return to either party, the profit split method is unlikely to be the most appropriate method.~~

~~16.~~ 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 ~~However,~~ 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

~~17.~~ 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 ~~if~~ 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.

~~18.~~ 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 –

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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]

Example 1:

Company A and Company B each contribute a unique and valuable intangible

Example 2:

Unique and valuable contributions not in the form of intangibles (similar to tea example from TPG)

Highly integrated operations

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.

~~19.~~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 ~~high~~-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.

~~20.~~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.

~~21.~~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 ~~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.

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Example 3

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.

Example 4

Long-term interdependency

Example 5

Complementary but discrete activities – not sufficiently highly integrated to warrant profit split

Shared risks

~~22~~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.

~~23~~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 6

Shared assumption of risks

Availability of information

~~24~~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

~~25~~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

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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.

The following paragraph still remains under discussion in the Subcommittee and will be presented for consideration by the Committee at a later stage.

~~[26]Where a profit split of actual profits is used, the profit split calculations will necessarily need to be performed some time after the transactions are entered into. However even in these cases, the way in which the profit split is to be applied should be established on the basis of information known or reasonably foreseeable by the parties at or before the time of the transaction(s).~~

~~26:24.~~ [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). ~~Different~~ A 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. ~~For instance~~ 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) for example, a different way of determining the relevant profits or how to split them, may be warranted. In such cases, documenting the reasons for the different application would be essential.]

~~27:25.~~ 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.

<p>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.</p>	<p>28:26. There are several ways in which the profit split method can be applied.</p>
	<p>Contribution Analysis</p>
<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>29:27. 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 <u>between unrelated enterprises or between the taxpayer and an unrelated enterprise,</u> should be used to support this allocation where available. However more</p>

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	<p>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>30.<u>28.</u> 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>
	<p>Residual analysis</p>
<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>31.<u>29.</u> 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 <u>one or more</u>each parties <u>to the controlled transaction(s) makes some-a contribution(s) which are-is routine</u>relatively less complex 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</p>	<p>32.<u>30.</u> <i>Step 1</i>: allocation of an arm's length profit to each enterprise <u>to compensate it-in-relation</u> for its less-complex, 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 <u>routine or benchmarkable contributions</u>less-complex activities only. 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</p>

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<p>TNMM is used to determine the appropriate return in Step 1 of the residual analysis; and</p>	<p>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>33.<u>31.</u> <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 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>34.<u>32.</u> As has been noted above, since reliable, direct information on how profits would have been allocated in comparable uncontrolled transactions is rare <u>might not be available</u>, 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> <p>Example</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, or ‘routine’ <u>or benchmarkable</u> arm’s length return to Company X for its manufacturing function, and a basic, or ‘routine’ <u>or benchmarkable</u> 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</p>

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	<p>'routine' returns to Company X and Company Y, will be the residual profit. This residual profit is 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;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>35.<u>33.</u> 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;² 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 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>36.<u>34.</u> The Rresidual approach is used more in practice than the contribution 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 or benchmarkable functions based on comparables and the application of a one-sided method. 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</p>

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

²A disadvantage of this approach is that cost may not reflect the market value of the intangible property.

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	<p>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>(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</p>	<p>37.35. [added from B.3.3.18] Example: application of residual profit split³</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> <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</p>

³ [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>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 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</p>	<p>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 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</p>
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<p>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>XYZ contributed a third (or \$0.20 per dollar of sales). Accordingly, it is determined that an arm's length royalty for the Stelon license for the Y1 taxable year is \$60 Million, i.e. one-third of XYZ-Asia's \$180 Million in residual Stelon profit.</p>
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<p>B.3.3.15. Comparable Profit Split Method</p>	<p>Comparable profit split method</p>
	<p>38.<u>36.</u> 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

~~39.~~37. 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.

~~40.~~38. 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 standards~~ and currency used. As this can materially affect the application of the method, consistency over time is important in this regard.

~~41.~~39. 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)

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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.

Example

Measures of profit

~~42.~~40. 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

Actual or anticipated profits

~~43.~~41. 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.

~~44.~~42. 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.

~~45.~~43. ~~The most~~ 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 ~~transferred~~ intangibles of Companies A and B, intangible X, 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

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due to Company A needs to be made should the intangible actually be more or less successful than anticipated.

~~46.~~44. 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, 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.

~~47.~~ [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 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.]

~~48.~~45. [new] 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 remains under discussion in the Subcommittee.

Profit splitting factors

~~49.~~46. 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.

~~50.~~47. 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.

~~51.~~48. 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.

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~~52.~~49. 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.

~~53.~~50. 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.

~~54.~~51. 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.

~~55.~~52. 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.

Examples

Changes to other parts of the Manual:

Glossary of terms

Existing text of the Practical Manual	Proposed revised text
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.	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.

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<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>
<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>

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</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>

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Profit Split Method. Valuation techniques can be useful tools in some circumstances.	
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PART C.2

PRACTICAL IMPLEMENTATION OF A TRANSFER PRICING REGIME

NOTE: SECTION C.1.1.4, COMPRISING C.1.1.4.1 – C.1.1.4.8 WOULD BE DELETED IN ITS ENTIRETY BECAUSE ITS SUBSTANCE DUPLICATES MATERIAL NOW FOUND IN NEW SECTION C.2., BELOW. OTHER MEMBERS OF THE SUBCOMMITTEE ARE WORKING ON A MORE DETAILED REVISION OF C.1.

ESTABLISHING TRANSFER PRICING CAPABILITY IN DEVELOPING COUNTRIES. [NOTE: THIS SECTION, PREVIOUSLY C.5., IS PROPOSED TO BE MOVED TO BECOME SECTION C.2. IN THE NEW 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 SHOULD BE RENUMBERED ACCORDINGLY.

~~5. — Establishing Transfer Pricing Capability in Developing Countries~~

~~C.5.1.~~

C.2.1. Introduction

1. ~~[C.5.1.1.—.]~~ This Chapter addresses issues ~~of~~ 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

~~widely recognized to be key features of modern tax administrations. These include factors such as:~~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 ~~reflects them~~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 ~~fine tuning~~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,~~even though.~~ 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 ~~decisions taken at a wider policy and the country’s overall~~ tax administration ~~level~~and legal structures.

C.5.2. 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 ~~in most jurisdictions~~. The other revenue generating organs of government (e.g. the customs service)⁸⁶ are also usually separate from

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->

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the tax administration ~~in many jurisdictions~~. 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, ~~particularly~~. 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; ~~and~~
- 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; ~~and the large amounts of money that may be at stake.~~

~~4.[C.5.2.2.—An essential first step in improving cooperation is to review and clarify exactly what each agency's.]~~ The respective responsibilities and functions ~~are and of~~ the tax administration and of the policymaking function should be clear. Mechanisms for contact and coordination. ~~This review between the two~~ should be ~~used to examine the scope for removing well understood~~. Duplication and overlap of functions, ~~and for streamlining and consolidating procedures~~ 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, ~~but also~~ and so that practical lessons from the administration of the ~~regime~~ tax administration can ~~be used as~~ 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;

issues/revenuepackage/~media/36DE1A4DC54B47109514FFCD0AAE6B0A.ashx.

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- 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
- ~~Utilizing~~ Where the experience of the administration and competent authorities in taxpayer service, education ~~and~~, enforcement, and ~~feedback from competent authorities~~ case resolution can aid in improving legislation or implementing regulations;
- Cross-secondment of tax administrators and policymakers to each other's teams. ~~This will~~ 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;
- ~~Broader governmental policies to ensure that all investment policies with a tax dimension must have the~~ Involvement of the tax administration. ~~For example, tax administrators should be involved 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
- ~~Recognition that policymakers should not be limited in their training to the economic effects of investment; but tax policy should also be incorporated into the training. Conversely, tax officials should also recognize the importance of investment to development and the importance of, for example, seeking to avoid double taxation in accordance with applicable law.~~

C.52.3. 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

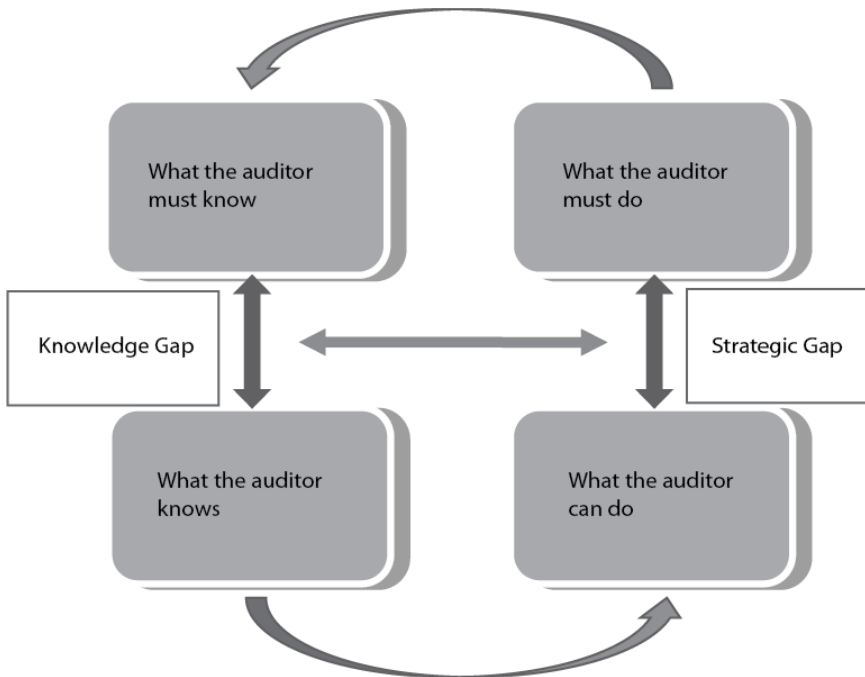
to consider when formulating policies, ~~which is not always the case.~~ In many cases, there is an unrealistic expectation ~~of an increase~~ that increases in capability across too many areas can be achieved in ~~too~~ a short ~~a~~ time. Skill in administering transfer pricing rules can only be developed by practical experience in addressing actual transfer pricing cases.

7.[C.5.3.2.—.] In addressing the issue of ~~developing~~ building transfer pricing capability it is important, ~~first of all,~~ to ~~determine~~ 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 ~~capability~~ capacity building plan—~~what~~. This is ~~often~~ sometimes termed a “life cycle approach”. A possible approach is outlined below in Figure C.5.1.⁸⁷

Figure C.5.1:
Audit Process

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).

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

- Levels of education and expertise of personnel involved with administration of transfer pricing rules;
- The legal environment or framework (as addressed in Chapter **B-8C.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

⁸⁸Katherine 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/>.

~~and perhaps especially in a difficult and legally complex area such as transfer pricing;~~⁸⁹

- ~~Networks~~ 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.5.2.4. Developing the Mission, the Vision and the Culture of the Unit

C.5.2.4.1. Objectives

9. [C.5.4.1.1.—.] The ~~goals~~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 “mission²²~~representing 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

⁸⁹ Katherine Baer, Olivier Bonon, 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/>.

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expect from the administration, and what is expected from ~~them~~taxpayers in ~~the~~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 ~~organization~~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 ~~of,~~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.

C.5.2.4.2. 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, ~~those~~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 ~~most effectively and efficiently~~ further ~~all these~~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

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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 ~~avoiding~~avoid unnecessary differences of opinion. They need to ensure, where possible, that those differences do not lead to ~~a dispute~~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 ~~to try~~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 is 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 ~~and peak representative bodies~~ 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, ~~in particular,~~ taxpayers and the tax administration to explore shared interests such as in clarity ~~and~~ transparency, ~~as much~~and certainty ~~as possible,~~ to understand and reduce the risks of aggressive tax positions, to increase awareness of commercial realities, fairness and consistency between taxpayers, and ~~reduced~~to reduce the costs of compliance and collection.

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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 ~~an~~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 ~~tax guidance notes~~, 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.

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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;⁹⁰
- 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.

⁹⁰ 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.

C.52.4.3. 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:

- 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.—~~Ongoing issues of.~~] Issues and procedures related to risk assessment and management are considered in more detail in Chapter C.34. 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.⁹¹

~~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. ~~Examples of factors that have often been given special prominence for further investigation by administrations (without of themselves implying any mis-pricing) include situations where the local entity has:~~

- ~~➤ Reported losses for a number of years or more, especially if the losses start to accrue close to the time when a “tax holiday” ends;~~
- ~~➤ A high value of related party transactions compared to the taxpayer’s turnover and operating profit;~~
- ~~➤ Significant transactions with major counterparts from low tax or no tax jurisdictions, non-treaty partners and countries from which information will not be readily available;~~
- ~~➤ An economically unrealistic profit trend compared to industry trends, with no obvious explanation;~~
- ~~➤ Inconsistencies between inter-company contracts, transfer pricing policies and detailed transactional documents such as invoices and customs documents; or~~
- ~~➤ Significant royalty payments to related parties, especially if the intellectual property is not legally registered or appears to be in some part locally generated.~~

C.5.2.5. Organizational Structure for the Transfer Pricing Unit

~~25. [C.5.5.1.—.]~~ There are two basic types of ~~structure~~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

⁹¹ 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>.

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pricing units by industry or geography. Each has advantages and disadvantages, as follows.

C.2.5.5.2. 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 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.2.5.5.3. 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.

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- *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

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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 ~~and~~ 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.5.2.6. Building Team Capability

C.5.2.6.1. General Human Resource Management Issues

35. [C.5.6.1.1.—.] A new transfer pricing regime ~~is probably itself related to~~ 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

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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 ~~becan become~~ suitable as, managers, a strategy for recruiting and retaining technical leaders will also be necessary, ~~as well as ensuring that their expertise is shared among their colleagues~~. 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

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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—and They can be unwilling or dismissive about taking up transfer pricing issues. Further, setting up ~~such~~ 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; ~~and~~. 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.⁹²

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.5.2.6.2. 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;

⁹² 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/nr_gi_transfer-pricing-study.pdf.

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- 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.⁹³

41. [C.5.6.2.3.—.] Dealing with MNEs demands specific characteristics and competences. Transfer pricing is about how business operates and the ~~operation~~application of complex, ~~somewhat “fuzzy”~~, 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 administration in a worse

⁹³ Readhead, 2016, p. 24.

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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.⁹⁴ It was noted that such experts can share their experience and give auditors, for example, more confidence in demanding information from taxpayers.⁹⁵

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

⁹⁴ Readhead, 2016, p. 25.

⁹⁵ Readhead, 2016, p. 25.

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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 ~~and~~, the large amounts of money often at stake, ~~as well as 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. ~~This~~ 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 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

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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.⁹⁶ ~~The role of non government organizations in pressing for country by country reporting as an outcome in the OECD/G20 BEPS project⁹⁷ is just one instance of this new reality.~~

⁹⁶ See, for example, the discussion in Readhead, 2016, pp. 36-38.

⁹⁷ ~~See, for example, ActionAid and other civil society organizations, “A Civil Society Agenda for the OECD” Briefing note for OECD meetings, January 2010, available at http://www.taxjustice.net/cms/upload/pdf/Civil_100122_soc_agenda_for_OECD.pdf.~~

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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.

C.5.2.6.3. 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

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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. ~~Identifying opportunities and how to most~~

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~~effectively request such assistance is expected to be dealt with in a future appendix to this Manual.~~

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.⁹⁸ Training in management, negotiation and interpersonal/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

⁹⁸ Readhead, 2016, p. 26.

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.52.6.4. 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.⁹⁹

C.5.2.6.5. 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

⁹⁹ 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>.

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.5.2.7. 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, short-cuts 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.5.2.8. 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;

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- 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.](#)

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- 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.52.8.3. 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;

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- 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.5.2.9. 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

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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

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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.

[Insert short section on Kenya's experience]

PART C.4

[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 SHOULD BE CHANGED ACCORDINGLY]

~~C.3. AUDITS AND RISK ASSESSMENT~~

C.4. Risk Assessment

C.4.1. Introduction to Transfer Pricing Audits and Risk Assessment

~~C.3.1.1. As discussed in Chapter B.1., the establishment of an appropriate “arm’s length” result is not an exact science and requires judgment, based on sound knowledge, experience and skill. Owing to the complexities inherent in transfer pricing, a transfer pricing enquiry is usually complicated and can become a costly exercise both for a national tax authority and a taxpayer. It should therefore not be undertaken lightly; due consideration should be given to the possible complexities and to the amount of tax at risk.~~

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. ~~The outcome of.~~] An effective audit process ~~has~~ seeks to achieve two ~~aspects~~ important outcomes:

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- ~~Increased~~It seeks to enhance and incentivize future compliance (which indirectly contributes to future tax revenue and protection of the tax base); and
- ~~Increased~~It seeks to increase current tax revenues ~~(where cases are successfully audited)~~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. An increase of “current” tax revenues resulting from such audits may refer to revenues that would be collected in a year or two. The hard work involved in a transfer pricing audit may result in the collection of significant tax revenue adjustments that can benefit a developing country. However, such results do not come quickly and easily; considerable resilience is required due to the complexity and uncertainty inherent in transfer pricing issues. Transfer pricing units in both the tax administration and the private sector often come under significant scrutiny, as the returns from the resources devoted to developing transfer pricing capability tend not to be quickly achieved and are not always easily identifiable.~~

4. [C.3.1.4.] ~~The success of audits~~an audit often depends ~~a great deal on good case selection.~~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 ~~and subsequent case selection, alongside the provision of appropriate resources for actual audit of a case. There are various factors that could be used to “flag” higher risk transactions and these are discussed in more detail below.~~

5. [C.3.1.5—Materiality,⁴⁰⁰ ~~used in isolation, is not generally a reliable basis for risk assessment, as transactions are often over or undervalued~~

⁴⁰⁰~~Materiality is a concept often used in auditing and accounting. It denotes the significance of a stated amount, a transaction or a discrepancy~~

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~~due to transfer mis-pricing. Accordingly, where materiality is used as the primary basis for case selection, an undervalued transaction may be overlooked as it appears to be immaterial. This could be a direct result of the entities charging non-arm's length prices.~~

~~C.3.1.6. It is advisable to separate the risk assessment process for transfer pricing and thin capitalization purposes (depending on domestic legislation). Thin capitalization is generally easier to detect (particularly where a debt to equity ratio safe harbour is in place as is the case in most countries) and the auditing process may be shorter. Transfer pricing audits generally take much longer to resolve and are usually more complex.~~

~~C.3.1.7.1 Risk assessment should be carried out at the first step of an audit and should continue through the various stages of the audit subsequent to the initial. Risk assessment, similar to a constitutes an ongoing cost/benefit analysis, which helps to ensure the most efficient and effective use of tax administration time and resources. This should 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.~~

~~C.3.2. Organization and Staffing of Transfer Pricing Audits~~

~~C.3.2.1. Administrative Aspects~~

~~Administrative features~~

~~C.3.2.1.1. Tax administrations vary in terms of how their respective transfer pricing units are set up. The spectrum of transfer pricing work undertaken, policy regulations, geographic size, level and complexity of transfer pricing activity, quantum of the tax base, number of resources etc. may impact on how the transfer pricing division is structured within the tax administration.~~

~~to the financial accounts. In this context a small transaction by a large company may not be material to the financial accounts of that company, even if there is an error or discrepancy.~~

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~~C.3.2.1.2.—The following functions are nevertheless likely to exist in most countries with a fair degree of transfer pricing experience:~~

- ~~➤—Audit section: transfer pricing risk assessment⁴⁰¹ and audits;~~
- ~~➤—Specialist advisory function: provision of technical guidance on audits, dispute resolution (settlements) and negotiation of advance pricing agreements (APAs) etc.;~~
- ~~➤—Competent authority: mutual agreement procedures; and~~
- ~~➤—Advance pricing agreements/arrangements (APAs).~~

~~C.3.2.1.3.—In contrast, tax administrations in other countries may only have some of the aforementioned functions depending on their stage of transfer pricing advancement and development. For example, some countries do not have an APA programme or an established transfer pricing competent authority section.~~

Administrative models

~~C.3.2.1.4.—Generally, two types of structural models exist for organizing the transfer pricing capability; centralized and decentralized.~~

~~C.3.2.1.5.—One variation that may be considered is the establishment of specialist transfer pricing capabilities separated into functional units, i.e. risk assessment, audit, MAP and APA teams. There may be overlaps in the use of expertise and resources but to a large degree each functional unit will be individually staffed.~~

~~C.3.2.1.6.—An alternative approach within the decentralized model involves creating a specialist function at the centre of the tax administration to advise generalist auditors and tax inspectors on how best to conduct transfer pricing audits through the provision of technical support. It is rare for these specialists to conduct audits themselves but that can happen when issues are particularly complex or contentious.~~

~~C.3.2.1.7.—Both centralized and decentralized models can be applied at a national level or in regional centres throughout the country, are interchangeable and contain their own advantages and disadvantages.~~

⁴⁰¹In some instances, the risk assessment capability may be undertaken by a separate section distinct from the audit section.

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~~There is no established best practice and tax administrations should decide which option suits their needs. It may be advisable for developing countries to adopt a centralized model at the inception or during the infancy of the transfer pricing administration. This will enhance development of experience and capability, consistency and quality in audit approach and establishment of best practice. See Chapter C.5. and following for further analysis of the centralized and decentralized models.~~

C.3.2.2. Staffing and Resourcing

~~C.3.2.2.1. Transfer pricing is not an exact science and requires judgment and discretion; audits are often complex and time intensive. Owing to this, it is critical that adequate resourcing is available for such audits. Developing countries are generally more constrained in transfer pricing resources, and a tax administration can be challenged by the complexity and volume of audits. The matching of adequate and appropriate skills and resources to a transfer pricing audit is nevertheless critical to the efficient, timely and successful conclusion and even resolution of an audit.~~

~~C.3.2.2.2. The challenge most developing countries face is the ability to employ, develop and retain these resources. In this regard, developing countries need to be innovative and strategic. Implementation of targeted recruitment and structured training programmes will assist developing countries in attracting, developing and retaining transfer pricing skills. Training and development including challenge and variety in work scope within the public sector is also often an attractive aspect of government work, and tax administrations in developing countries need to leverage off this to attract and retain transfer pricing resources. See further C.5.6.1. and following paragraphs.~~

~~C.3.2.2.3. Most tax administrations employ a variety of skills within transfer pricing units. These include economists, lawyers, accountants, industry experts and generalists. Over time those become transfer pricing specialists. Where there are insufficient transfer pricing resources it is critical that any transfer pricing audit be staffed with at least one transfer pricing specialist.~~

~~C.3.2.2.4. It is neither practical nor good governance for a transfer pricing audit to be conducted by a single auditor (be it a specialist transfer~~

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~~pricing auditor or otherwise). Transfer pricing audits are generally conducted by teams of two or more persons with varying degrees of input from other team members. In most developed countries it is customary for every transfer pricing audit team to include an economist. In other countries, the presence of an experienced transfer pricing specialist is essential especially if the audit is done in partnership with the general audit section. This “mixed teaming” approach allows transfer pricing risk to be audited alongside other tax risks; it also allows greater flexibility in resource deployment and the sharing of complementary skills and experience.~~

~~C.3.2.2.5. Another approach adopted within centralized specialist transfer pricing teams is the partnering of less experienced transfer pricing specialists with more senior and experienced specialists. This allows for transfer of skills and knowledge sharing and is an effective way of building and growing capabilities.~~

~~C.3.2.2.6. Developing countries with transfer pricing resource constraints may consider the use of external consultants and experts. There are instances where some countries have made use of external economists and legal counsel to provide technical opinions on transfer pricing audits. While not the preferred approach, especially in view of the potential costs involved, this can be a short term solution.~~

~~C.3.2.2.7. Developing countries may want to explore the option of staff exchange with developed countries as a way of building capability and capacity. This could be a useful mechanism for developing countries to expand their transfer pricing capabilities as seconded staff from other countries could be utilized to train and develop transfer pricing resources and provide input into audits. Moreover, staff returning from abroad could be used to train colleagues.~~

~~C.3.2.2.8. Various international organizations such as the United Nations, World Bank/IFC Group, the International Monetary Fund, the African Tax Administration Forum (ATAF) and the OECD run training and advisory outreach programmes in the area of transfer pricing. These programmes are many and varied in content but are essentially aimed at bringing international expertise and best practice to countries in need of developing and furthering their transfer pricing regimes.~~

C.3.36. [C.3.1.6.] The OECD has recently published a very useful handbook on transfer pricing risk assessment.¹⁰² 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.3.34.2.1. 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. This A determination of whether the prices utilized by the taxpayer are in fact arm's length will depend on a full functional classification 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

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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. ~~This is very useful in risk identification and assessment, as the availability of all such relevant information can enhance the quality of the risk identification and assessment process.~~ 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. ~~Chapter C.2. of this Manual addresses~~ For relevant taxpayers, transfer pricing documentation requirements in more detail. 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.

¹⁰³

10. [C.3.3.1.4.] ~~A tax administration should ensure a balance between the cost of compliance for taxpayers and its own information needs. This~~

¹⁰³ 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.

~~is increasingly difficult given that transactions are becoming increasingly complex in nature. See Chapter C.2. for a more detailed in-depth analysis of transfer pricing documentation issues.~~

C.3.3.1.5.] A risk identification and assessment process followed by engagement with the taxpayer can ~~at times~~ 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 ~~again~~ 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.

C.3.3.2.2. 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 ~~classify~~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 ~~and complexity 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.

~~-of the risk, the possible quantum at stake and the probability of success (i.e. the likelihood of an adjustment, the level and number of resources that may be required etc.). Such classification can assist in determining whether a case is worth pursuing (now or later) and whether or not the requisite resources and expertise are available.~~

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

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~~that are not always readily identifiable. It is by no means exhaustive and it is acknowledged that additional classes and categories of risk may exist:~~

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

14. [C.3.3.2.4.] The risk classification provided here as an example ~~assists~~can assist the risk profiler/assessor in the evaluation of each of the following ~~in potential cases~~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: ~~Intentional~~ 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 ~~structure~~transactions or structures may be significant and the tax risk is therefore assumed to be high.

16. [C.3.3.2.6—It is, however, difficult to detect these structures through the general risk identification and assessment process as such structures are often not.] Important changes in corporate structure must now be disclosed. The likelihood of detection is therefore often low. In such instances in transfer pricing documentation. A tax administration’s awareness of possible tax planning schemes and structures ~~(for example,~~

~~through its disclosure and filing requirements) and its own analysis of potential loopholes in the tax system may trigger further investigation. This is, however, time and resource intensive, requiring experienced staff.~~ [help identify useful lines of audit inquiry.](#)

Category 2: **Intentional** 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. ~~Restructurings are not readily detectable but can be identified through static profit margins (where a subsidiary has been restructured from a full risk distributor to a limited risk distributor) or through changes in VAT returns etc.~~

[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 fully fledged 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 ~~would~~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.

~~C.3.3.2.12. — The likelihood of detection at the time of risk assessment with the limited information available would be moderate to low. On the other hand, the values at risk may be moderate to high (as a result of the intentional profit shifting that has occurred), but would in all probability require the involvement of experienced resources for an extended period of time to increase the likelihood of a successful audit.~~

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 ~~through~~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, ~~accordingly,~~ 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 ~~most~~ 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 likely possible that the values could be material ~~(in the sense of being large), but they would be less significant than in cases where an MNE is actively implementing a profit shifting scheme.~~ 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.

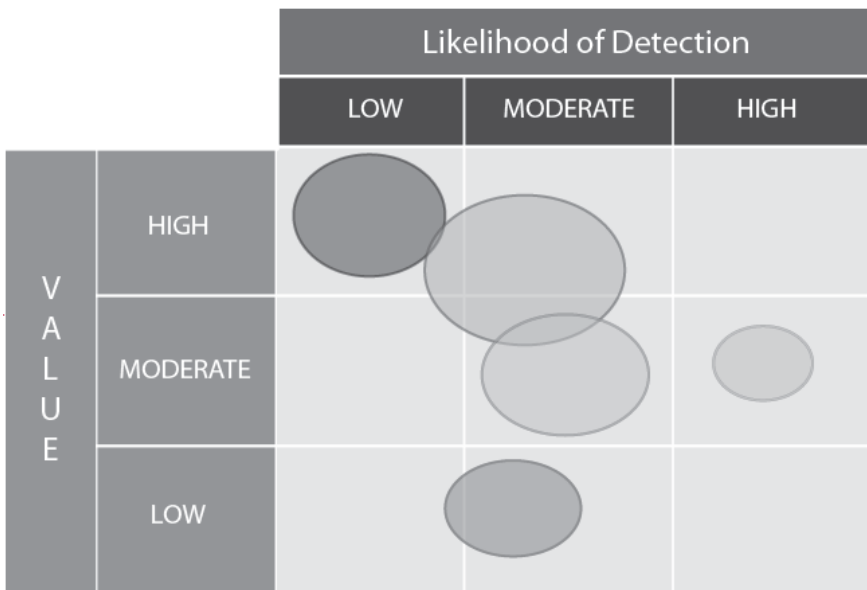
~~C.3.3.2.17.—The descriptions of the risk categories explained above are summarized on a simple matrix in Figure C.3.1 The likelihood of detection and the potential value of the risk is represented by the two axes and categorized as high, moderate or low. The size of the “bubble” in the diagram indicates the amount of time and resources required—the bigger the “bubble”, the higher the time and resource intensity likely to be required by the audit.~~

~~C.3.3.2.18.—Where transactions seem to fall into the above categories, it is also useful to evaluate the risks as classified and explained above, within the context of whether the risk is associated with an “inbound MNE”/“inbound transaction” or “outbound MNE”/“outbound~~

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transaction”. An “inbound MNE” is an MNE which is headquartered elsewhere but has a subsidiary in the country where the risk assessment is being undertaken. An “outbound MNE” is the opposite i.e. a group headquartered in the country where the risk assessment is being carried out with operations elsewhere in the world.

Figure C.3.1:
Likelihood of Detection



C.3.3.2.19. — An “inbound transaction” is a transaction where the goods or services are flowing into the country where the risk assessment is being conducted; and vice versa for an “outbound transaction”. It is worth noting that an outbound MNE may have inbound transactions. When evaluating the outbound MNE, certain flags would be triggered whereas the evaluation of the inbound transactions undertaken by the outbound MNE would trigger other risk issues. These are summarized in the table below:

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[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.34.1:
Possible “Flags” Suggesting further Investigation

TYPE	INBOUND TRANSACTIONS/MNEs	OUTBOUND TRANSACTIONS
Funding	Thin capitalization	Interest free loans
Interest rates	Excessive interest rates	Too low interest rates
Goods	<ul style="list-style-type: none"> ▪ Offshore procurement/sourcing companies to keep profits offshore ▪ General mis-pricing (intentional/unintentional) 	<ul style="list-style-type: none"> ▪ Offshore marketing to keep profits offshore ▪ General mis-pricing (intentional/unintentional)
Services	<ul style="list-style-type: none"> ▪ Excessive fees relative to benefit provided ▪ Charging when no service received ▪ Duplication/shareholder services 	<ul style="list-style-type: none"> ▪ No charge at all ▪ Excessively low prices for benefit provided
Intangibles/Intellectual property	<ul style="list-style-type: none"> ▪ Excessive charges ▪ Duplicating charges through royalties over and above inflated prices 	<ul style="list-style-type: none"> ▪ Not charging for intangibles developed locally ▪ Externalizing intangible value without reward
Structures	<ul style="list-style-type: none"> ▪ Restructuring ▪ New structures 	<ul style="list-style-type: none"> ▪ Restructuring ▪ New structure ▪ To avoid/minimize taxes through controlled foreign corporation ▪ Use of offshore base erosion anti-abuse tax jurisdictions with tax treaties

C.3.3.4.2.3. 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.3.3.4.2.4. 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.2.3.] for more information on transfer pricing documentation.

C.3.34.2.5. 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, ~~of course at most they.~~ Instead, these factors point to a higher than normal likelihood of such mis-pricing. ~~See below for some commonly agreed risk indicators; and suggest that~~ further ~~details are available in Chapter C.5.:~~ 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

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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.3.3.4.2.6. The Risk Assessment Process

[41.\[C.3.3.6.1.1\]](#) 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 ~~material~~ 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.3.34.2.7. 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.3.3.4.2.8. 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 ~~proceeding (including all workings), with an effective back-up strategy~~ [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

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- The outcome of the risk identification and assessment process, i.e. what was recommended and why. ~~This would be the most critical aspect.~~
- Specific issues and transactions identified for further audit.

PART C.5

[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.3.4.—Planning for a Transfer Pricing Examination~~

C.5. Transfer Pricing Audits.

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.3.45.1.1.1.] 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;

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- 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; ~~and~~
- 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;

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- 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.3.45.1.2. 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.3.45.1.3. 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.¹⁰⁴ ~~This~~ 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.3.45.1.4. 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

¹⁰⁴ 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.

the progress of the audit periodically to reconsider the audit timetable and the extent of information needed by the audit team.

C.3.45.1.5. 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.3.45.1.6. 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 ~~to create documents or to put necessary data in an orderly form~~ for the taxpayer to explain the business operations ~~and to proceed to the analytical stage.~~ 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

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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 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. \[C.3.4.6.5.1\]](#) 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.3.45.1.7. 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.3.45.1.8. 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.3.5.2. Preliminary Examination

C.3.5.2.1. 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;

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- 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.3.5.2.2. 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;

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- 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. \[C.3.5.2.3.1\]](#) The following questions are among those which may be asked in order to understand the taxpayer's operations:

[26. \[C.3.5.2.4.1\]](#) 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. \[C.3.5.2.5.1\]](#) If the taxpayer is engaged in the *manufacturing* of products:

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- 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.3.5.2.3. 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;

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- 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.3.5.2.4. 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 ~~further~~ [Chapter C.52., above](#).

C.3.5.2.5. Audit Procedure

C.3.5.2.5.1. 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.3.5.2.5.2. 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.3.5.2.5.3. 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

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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.3.5.2.5.4. 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.¹⁰⁵ 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.

C.3.5.2.5.5. 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

¹⁰⁵ Japanese Special Taxation Measures Law Art. 66–4, paragraph 8.

tax examiners in charge of transfer pricing taxation are trained to understand English and may be able to read documents in English.

C.3.5.2.5.6. 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 ~~would~~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.3.5.2.5.7. 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

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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.3.5.2.5.8. 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.3.5.2.5.9. 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

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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

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- 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.3.5.2.5.10. 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

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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.3.5.2.5.11. 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.3.5.2.5.12. 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.3.5.2.5.13. 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.3.5.2.5.14. 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.

Table C.3.25.1:
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)		

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Gross profits and margins (five years)		
Operating profits and margins (five years)		
Gross profit margins after adjustments		

C.5.3.6. Narrowing of Issues: Development of Tax Authorities' Position

C.5.3.6.1. 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.5.3.6.2. 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.5.3.6.3. Refining ~~Functions and Risk~~ 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.5.3.6.4. 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.5.3.6.5. 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 ~~an~~ 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.5.3.6.6. 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.5.3.6.7. 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.5.3.6.8. 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.5.3.6.9. 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. \[C.3.6.9.2.1\]](#) 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. \[C.3.6.9.3.1\]](#) 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.3.75.4. Case Closure

[86. \[C.3.7.1.1\]](#) 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.3.85.5. Relationship between Transfer Pricing Audits and Advance Pricing Agreements

[87. \[C.3.8.1.1\]](#) 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. \[C.3.8.2.1\]](#) 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

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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.](#)

Table C.3.35.2: Audit Closure Template

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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			

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

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2011		
2012		
2013		
2014		
2015		
2016		

8. TAXPAYER'S BANK ACCOUNT(S) DETAILS	
BANK NAME	ACCOUNT NUMBER

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

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Name, Signature and Date

13. OBSERVATIONS BY TEAM LEADER			

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14. ENDORSEMENT BY MEMBERS OF THE TEAM			
NAME	DESIGNATION	SIGNATURE	DATE

NAME	DESIGNATION	SIGNATURE	DATE