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**Committee of Experts on International
Cooperation in Tax Matters
Twenty-First Session
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Item 3(d) of the provisional agenda
Update of the United Nations Practical Manual on
Transfer Pricing for Developing Countries**

Co-Coordinators' Note

Summary

This note summarises work by the *Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing* towards updating and making more practical the *UN Practical Manual on Transfer Pricing for Developing Countries*, and attaches for consideration and **final approval some draft text previously put before the Committee at its 20th Session**.

The paper also encloses at Attachments D.1 and D.2, for the information of the Subcommittee, the available components, composed by countries, of Part D of the Manual. These comprise updated contributions from South Africa and Mexico. We have been advised that the contribution from Brazil will not be altered at this stage. Updated contributions from China and India are expected as well as a new contribution from Kenya. These will be made available for information as they are provided.

The nature of Part D as indicated in the Foreword to the First Edition Manual (when it was Chapter 10) is that it does not purport to represent agreed Committee decisions:

Chapter 10 is different from other chapters in its conception, however. It represents an outline of particular country administrative practices as described in some detail by representatives from those countries, and it was not considered feasible or appropriate to seek a consensus on how such country practices were described. Chapter 10 should be read with that difference in mind.

This fundamental characteristic of the Country Practices part of the manual is why the texts are only provided, as for past editions of the Manual, for Committee information, rather than for approval.

As noted in the report on this item for the 20th Session, and again in this note, the Subcommittee proposes that Part D remains part of the Manual, with the same status of before, but that it be made available only online, at a site indicated in the paper version of the Manual, rather than in that paper version itself. This will facilitate any changes in the life of this edition of the Manual and prevent it becoming prematurely outdated as a publication. **Approval is sought for this approach. A proposed foreword for the new edition of the Manual is also provided for information.**

I. BACKGROUND

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

II. THE MANDATE

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

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

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

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

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

III. THE CURRENT SUBCOMMITTEE'S WORK

3. The Subcommittee currently 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 necessary and it continues to operate very successfully.

4. As proposed by the Subcommittee at the 17th Session and approved by the Committee, the next version of the Manual, due by 2021, is designed to 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. Improved capacity development based on the Manual has encouraged and contextualized developing country feedback, helped identify these priority areas for improvement and contributed to honing the messages in the Manual and examples used.

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

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

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

- Comparability;
- Group synergies and centralized procurement functions; and

- The general legal environment and establishing and updating transfer pricing regimes.

8. After the 19th Session of the Committee, a Subcommittee meeting was held on 2-4 December 2019 in Nairobi; back to back with the UN Regional Workshop on Transfer Pricing (Profit Shifting) on 5-6 December 2019, designed to draw upon the expertise of Subcommittee Members in issues relevant to the region and to feed learnings of that event into the work of the Subcommittee and the next version of the Manual. The Nairobi Subcommittee meeting focused on updating the drafts presented at the 19th Session as well as preparing texts on the following topics:

- Part B - Design Principles and Policy Considerations - B.1. Introduction to Transfer Pricing;
- Revised and additional guidance on Group Synergies and Centralized Procurement Functions;
- A revised Chapter B.2 on Comparability; and
- Thorough revision of Chapter B.8 General Legal Environment and Chapter C.1. Establishing and Updating Transfer Pricing Regimes.

9. A meeting in Vienna in February 2020 was hosted by the Austrian Ministry of Finance and the Vienna University of Economics and Business. At that meeting, further discussion and progress was made on most of those topics, including preparation of text for first consideration at the 20th Session., as enumerated below. The meeting included, in particular, an in-depth discussion of the proposed examples for the Financial Transactions Chapter. There has been no Subcommittee meeting since, in either physical or virtual format, but as the work has effectively been completed at Subcommittee level, that has been consistent with the Subcommittee workplan.

IV. DOCUMENTS FOR CONSIDERATION OR APPROVAL

10. The documents attached **for second consideration** (the first consideration being at the 20th Session **and approval by the Committee at its 21st Session** are as follows (the numbering is subject to change for the final Manual, but is used for ready reference by the Committee):

*Documents for a **second consideration and approval** after an initial consideration at the 20th Session:*

- Thorough revision of **Part A: Transfer Pricing in a Global Environment** to reflect, in particular, the nature and impact of new business models in a digitalized environment. (*Attachment A*);
- Thorough revision of **Chapter B.1: Introduction** to improve focus and avoid unnecessary overlaps and repetitions. (*Attachment B.1*);

- **Revised Chapter B.4.2.7: Relationship Between Transfer Pricing and Customs Valuation. (Attachment B.3);**
- **Chapter B.4.2.10.1-7: Additional targeted and focused guidance on Centralized Sales Functions. (Attachment B.5);**
- **Chapter B.8 (previously referred to as B.9) on Financial Transactions (examples only) reflecting and making more practical and understandable the guidance already approved by the Committee (to B.9.3.) or for which a final approval is sought at the 20th Session (B.9.4). (Attachment B.7); and**
- **Revised Chapter C.6. (formally C.4): Dispute Avoidance and Resolution. (Attachment C).**

V. A MATRIX OF THE STATUS OF TEXT

11. The state of the papers and proposed or historic dates for consideration or approval can be summarized as below, color coded as to projected final consideration (with those for which final approval is sought at this 21st Session being in yellow) as follows:

Committee Consideration completed (at 19 th Session) – only included for context	Committee Consideration completed (at 20 th Session) – only included for context	Projected final consideration at 21 st Session
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Component Part	First Reading Session	Approval Session	Attachment
A: Transfer Pricing in a Global Environment	20th	21st	A
B.1: Introduction	20th	21st	B.1
B.2: Comparability	19th	20th	B.2
B.2.4.7: Transfer pricing and customs valuation	20th	21st	B.3
B.3.3: Profit Splits	18th	19th	B.4
B.4.2.10.1-7: Additional Guidance on Centralized Sales Functions	20th	21st	B.5
B.5: Group Synergies and Centralized Procurement	19th	20th	B.6
B.9: Financial Transactions (excluding B.9.4 (guarantees) and the examples)	18th	19th	B.7
B.9.4: Financial Transactions (guarantees)	19th	20th	B.7

B.9: Financial Transactions (the examples)	20th	21st	B.7
C.1: merging and updating former Chapter B.8 on the General Legal Environment and former Chapter C.1. on Establishing and Updating Transfer Pricing Regimes	19th	20th	C (All chapters in Part C are in a single attachment)
C.2: Establishing Transfer Pricing Capability (previously C.5) NB, C.3 on Documentation was C.2.	18th	19th	C
C.4: Risk Assessment (Previously part of C.3.)	18th	19th	C
C.5: Transfer Pricing Audits. (A new Chapter, but basically picking up former C.3.4 to C.3.8).	18th	19th	C
C.6 (formerly C.4) Dispute Avoidance and Resolution	20th	21st	C

VI. PREVIOUSLY APPROVED TEXT

12. To allow the Committee to have a sense of the emerging Manual as a whole, previously approved text, or parts for which no change is sought, is included but in shaded font, to make clear that guidance and comment is not sought on it at the 21st Session. The text as a whole will be subject to a non-substantive editing process before it is published, as usual, under the supervision of the Co-Coordinator. That process has already commenced.

VII. PART D (COUNTRY PRACTICES)

13. Updated text of **Part D (Country Practices)** is being sought from countries which included their practices in the 2017 version of the Manual, should they wish to continue to include their practices. Kenyan practices will be added. As a mere expression of a particular country's practices, approval of the description of such practices is (as in the past) not sought or appropriate. The new South African contribution is at **Attachment D.1**. The new Mexican contribution is at **Attachment D.2**.

14. The proposal made at the 20th Session and repeated at this Session is to remove Part D to the Tax Committee website. Paragraph 67 of the Report of the 20th Session notes in this respect that:

Finally, attention was drawn to paragraph 14 of [E/C.18/2020/CRP14](#), noting the possibility of removing Part D (Country Practices) to the Tax Committee website

to confirm that its content is not Committee reviewed and approved, unlike the rest of the Manual, to allow it to be updated more readily, and make the Manual itself a slimmer volume in paper form. Part D would still have the formal status of being part of the Manual. While no comment was made on this proposal at the virtual meetings, the matter remains open for further discussion at the twenty-first session.

15. The proposal would allow Country Practices to be updated more readily and make the Manual itself a slimmer volume. As it is not the sort of material needed by officers in the field, removal to the website would if anything render use of the (slimmer) Manual in the field easier. Some of the material in Part D is also likely to be somewhat outdated in the life of the third edition of the Manual, and this would allow updating the Manual without having to reprint the paper version. Nevertheless, Part D would remain part of the Manual, merely accessed electronically rather than in the printed version.

VIII. TRANSFER PRICING AND THE EXTRACTIVES

16. As well as its work providing a draft updated Manual, the Subcommittee will assist the Extractives Subcommittee in Updating the Transfer Pricing chapter of the *United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries*, especially through the good offices of those who are Members of both Subcommittees.

IX. FOREWORD TO THIRD EDITION

17. A draft Foreword to the Third Edition of the Manual is at **Attachment E**. This is included **for information only**, as it does not raise any new issues of substance.

X. NEXT SUBCOMMITTEE MEETING

18. A Subcommittee meeting *may* be necessary before the Committee's 22nd Session to take on board any relevant suggestions arising out of the 21st Session. It would most likely be held virtually if deemed necessary.

19. Thanks are due to all Subcommittee Members, especially those with drafting responsibilities, for preparing and commenting on drafts in the difficult recent circumstances, and to their employers.

This Part was first considered at the 20th Session and is for approval at the 21st Session

PART A: TRANSFER PRICING IN A GLOBAL ENVIRONMENT

A.1. Introduction

A.1.1. This chapter provides background material on multinational enterprises (MNEs); MNEs are a key aspect of globalization as they have integrated cross-border business operations. The chapter describes the factors that gave rise to MNEs and shows how an MNE is able to exploit integration opportunities in the cross-border production of goods and provision of services through a “value chain” (or “value-added chain”). The term “value chain” is defined in this Manual as “the process or activities by which a company adds value to an article, including production, marketing, and the provision of after-sales service.”¹

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

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

A.2. Development of Multinational Enterprises

A.2.1. Firms are organizations that arrange the production of goods and the provision of services. The aim of a firm is to produce goods and provide services to maximize profits. In the absence of MNEs, production would be carried out through a series of arm’s length transactions between independent parties². These transactions would require contracts between the independent producers, but a significant part of these resources would be used in the process of making contracts. Firms become MNEs as the firms grow, expand and diversify their operations internationally. Rapid advances in technology, transportation and communications have given MNEs the flexibility to place their enterprises and activities almost anywhere in the world.

A.2.2. The expenses of making contracts are called “transaction costs” since expenses are incurred by entities in finding other entities with whom to contract, as well as in negotiating and finalizing the contracts. As contracts cannot cover every possible issue that may arise

¹ Oxford English Dictionary Online; https://en.oxforddictionaries.com/definition/value_chain.

² UNCTAD, *World Investment Report 1993: Transnational Corporations and Integrated Production*, “World Investment Report 1993” (New York, 1993). Available at http://unctad.org/en/Docs/wir1993_en.pdf, at p. 115; Ronald Coase, “The Firm, the Market and the Law”, (Chicago: University of Chicago Press, 1988) at p. 7.

between the contracting parties, there is a risk of disputes being created as a result of unforeseen contingencies. When disputes occur between contracting parties, they may incur considerable costs in resolving these disputes including negotiation costs, legal expenses, and litigation and mediation expenses. As transactions and associated costs would be significant in an economy without firms, it is rational for firms to be created to produce goods and services, provided that the firms' costs of production are less than the costs of outsourcing the production.

A.2.3. Within a firm, contracts between the various factors of production are eliminated and replaced with administrative arrangements. Usually, the administrative costs of organizing production within a firm are less than the cost of the alternative, which is outsourcing market transactions. The theoretical limit to the expansion of a firm is the point at which its costs of organizing transactions are equal to the costs of carrying out the transactions through the market. A firm will internalize the costs of production to the extent that it can achieve economies of scale in production and distribution and establish coordination economies.

A.2.4. MNEs create organizational structures and develop strategies to arrange the cross-border production of goods and services in locations around the world and to determine the level of intra-entity or intra-group integration. The structure of transactions within an MNE is determined by a combination of market and group driven forces which can differ from the open market conditions operating between independent parties. A large number of international transactions within MNEs are therefore not governed directly by market forces but driven by the common interest of the MNE group.

A.2.5. Successful MNEs use their location and internalization advantages to maximize their share of global markets and growth opportunities. Thus, multinational enterprises are able to minimize their costs through their integration economies, which are not available to domestic firms.

A.2.6. A key feature of MNEs is that they have integrated (global) supply chains. A supply chain is a collection of suppliers required to create one specific product or service for a company. Each supplier is a link in the end to end supply chain. If those links/enterprises are under common control, the enterprises may be considered as "associated enterprises". The term "supply chain" is defined as "the chain of processes involved in the production and distribution of a commodity."³ The process of running and improving the efficiency of the supply chain for the benefit of the most, if not all of the links in the supply chain, can be a feature of the value chain of the MNEs.

A.2.7. Globalization has made it possible for an MNE to achieve high levels of integration and the ability to have control centralized in one location. Modern information and communications systems also provide increased horizontal communications across geographic and functional business lines. This has resulted in many MNEs providing services such as advisory, research and development (R&D), legal, accounting, financial management, and data processing from one or several regional centres to group companies. Also, management teams of an MNE can be based in different locations, leading the MNE from several locations. From the perspective of the MNE these resources need to be allocated with maximum efficiency in an optimal manner, may contribute to an optimal value chain.

A.2.8. International business has experienced far-reaching structural change with the rise of service and knowledge-intensive industries and, with the expansion of the internet economy,

³ Oxford English Dictionary Online; <https://en.oxforddictionaries.com/definition/value-chain>

service and technology enterprises are playing an increasingly important role in the international marketplace.⁴

A.2.9. Where in the past MNE's mostly operated in physical markets and through presence in multiple jurisdictions, with the current pace of digitalisation of the economy, some MNEs are now able to conduct significant business in places where they do not have any physical presence. This makes addressing the taxing rights of the respective countries to avoid double or non-taxation particularly challenging.⁵

A.2.10. The rapid evolution in MNEs is also reflected in the rise of many developing economies where foreign investments have grown significantly. In developing countries, MNEs have diversified well beyond primary production and extractive industries into manufacturing, assembly, domestic market development and services, utilising transport and other infrastructure, skilled labour and low productions costs.

A.2.11. The activities of multinational enterprises, through international trade and investment, have strengthened and deepened the ties that join countries in an increasingly inter-dependent world. These activities can bring substantial benefits to home and host countries. These benefits accrue when multinational enterprises supply the products and services that customers want to buy at competitive prices and when they provide fair returns to suppliers of capital. Their trade and investment activities contribute to the efficient use of capital, technology and human and natural resources.⁶

A.2.12. MNEs have common control, common goals and common resources, and the units of the enterprise — parent company, subsidiaries and branches — are located in more than one country. Thus, many MNEs are fully integrated businesses that plan and implement global strategies. UNCTAD has noted, however, that integration of production by MNEs creates challenges for policymakers in adapting the methods for allocating the income and costs of MNEs between jurisdictions for tax purposes.⁷

A.2.13. In *Multinational Enterprises and the Global Economy* (2008)⁸ the authors argue that the history of MNEs was shaped by political, social and cultural events that influenced the ownership, organization and location of international production of their goods and services. The authors claim that MNE groups tended to integrate their operations until the late 1980s and then more recently moved to outsource some activities in which they do not have competitive advantages.

A.2.14. For most of the twentieth century, the same authors note, MNE groups and international enterprises operating through branches or subsidiaries tended to expand the range of their value adding activities and by the late 1980s MNEs had integrated their production and marketing functions. Up to the 1960s and 1970s, MNEs had engaged in limited or no outsourcing of operations and they became large integrated conglomerates. But the authors argue that from the late 1980s MNEs began outsourcing many activities that were previously performed by the companies themselves.⁹ From the early 1990s, MNEs began restructuring to specialize in the areas in which they had competitive advantages, such as unique firm-specific

⁴ Preface OECD Guidelines for Multinational Enterprises

⁵ Press release OECD 9-10-2019 OECD leading multilateral efforts to address tax challenges from digitalization of the economy

⁶ Preface OECD Guidelines for Multinational Enterprises

⁷ [footnote to be added]

⁸ John Dunning and Sarianna Lundan, "Multinational Enterprises and the Global Economy", 2nd edition, (Cheltenham, Edward Elgar, 2008) at p. 197.

⁹ Idem, p. 196.

assets, in particular high value intangible assets, and the capabilities that provided the firms with their market position and competitive edge.

A.2.15. MNEs examined their value chains to identify the functions in which they had no advantage over other firms.¹⁰ They then began deciding on which functions they would perform themselves and which functions could be outsourced to independent firms or centralised shared service centers, a process called “value chain optimization”. For in-house services, MNEs might decide to provide some services through centralized service centres. While the initial functions that were outsourced were non-core activities such as payroll, billing and maintenance services, outsourcing has expanded to cover core activities. The core activities may involve producing goods or providing services. For example, many firms outsource call centre activities or certain administrative functions to (in)dependent firms in countries which have educated workforces and relatively low-cost labour. Consequently, modern MNE groups organize their cross-border operations through a network of contractual arrangements with (in)dependent enterprises and cooperative in-house relationships.

A.2.16. MNEs vary in size and include some small and medium-sized enterprises (SMEs). When SMEs commence operating in other jurisdictions through locally incorporated subsidiaries, they will usually incur the additional requirement of complying with transfer pricing rules. Some SMEs may face challenges in complying with transfer pricing rules because of their lack of expertise with international tax issues in general and limited compliance resources that may hinder them from expanding their operations abroad.

A.2.17. Consequently, domestic transfer pricing rules which apply to SMEs should reflect the capacity of SMEs to comply and the capacity of the tax authorities to administer such rules. Some countries may have special simplified rules for SMEs, such as simplified documentation requirements, and may use flexible approaches in handling transfer pricing issues involving SMEs. This creates the need to define an SME. Although there is no universal definition, an SME may be defined on the basis of criteria including: turnover; balance sheet value; number of employees; and transaction values.

A.3. Corporate Structures

A.3.1. General Principles of Company Law

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

A.3.1.2. One of the key decisions any MNE needs to take when expanding its operations is the type of legal structure it will use to operate. There are many alternatives for an MNE to operate either through locally incorporated subsidiary companies (associated enterprises) or else through permanent establishments (branches). Subsidiaries may be either fully owned by the parent company or partly owned. An MNE may also operate by using an agent, which may be an independent agent, a dependent agent or a commissionaire. Other alternatives may be

¹⁰ Ibid.

expanding via a partnership and limited liability partnerships. Depending on the domestic law treatment of a partnership, it may be treated as a fiscally transparent entity with flow-through treatment, or else it may be treated as a taxable entity.

A.3.1.3. MNEs can also carry out their business through a joint venture. Joint ventures involve independent businesses (which could themselves be incorporated entities, branches or partnerships) working together on a specific project. Joint venture partners can include a government agency or an entity that is normally a competitor (subject to competition policy/ antitrust rules).

A.3.1.4. MNEs have a broad choice of legal forms through which they may carry out their operations in individual countries under the company law of the respective country. The choice of legal structure may be affected by a number of factors, apart from the tax implications, including legal liability, risk and control, financing and administrative and regulatory obligations and costs. However other factors may play an important role as well, for example: exchange controls, “partnerability” (i.e. how well an entity is set up and managed to operate as a partner with others) “bankability” (i.e. having sufficient profit, assets, and liquidity to get a loan at a bank), requirements for minimum shareholding by local persons or entities, administrative costs, extraction of profits and capital requirements.

A.3.1.5. Legal structures used by MNE groups vary and evolve over time. The business structures used by an MNE group may similarly change over time such as, for example, commencing operations in a jurisdiction using a joint venture structure and then buying out the joint venture partner and operating in that jurisdiction through an associated enterprise.

A.3.1.6. In an MNE group, the parent company and subsidiary companies are separate legal entities and they may enter into intragroup transactions. On the other hand, an international enterprise with a head office in one country and a permanent establishment in another country is considered one legal entity. As such a permanent establishment itself cannot legally enter into transactions with other parts of the enterprise because transactions require at least two legal entities.

A.3.1.7. Company law also in many respects determines how corporate entities are governed. “corporate authorities”, the powers exercised by various officers of an entity, originate from the respective legal authorities accorded to entities within the MNE. The Board has the authority to exercise all of the corporation’s powers; and it delegates authority to act to certain company officers in certain circumstances. This includes delegating locally in accordance with a local legal entities’ requirements. The execution of a corporate authority binds the legal entity and consequently delegates must be aware of local legal and tax cross-border requirements as company and/or personal liability may arise as a result of the execution of such an authority.

A.3.1.8. Corporate and tax laws view corporations as separate entities, with parent companies, subsidiaries and affiliates all legally distinct from each other. The separate existence of the subsidiary may be manifested, for example, by having its own properly constituted management, its own business purpose and its own assets appropriate to that purpose.

A.3.1.9. The boards and management of subsidiaries continue to hold fiduciary duties to control and manage the assets of, and to govern and manage the operations of, their respective subsidiaries and are not required to implement a shareholder request if implementation conflicts with those fiduciary duties (e.g. the request contravenes local law).

A.3.1.10. “Organizational authorities” are the risk-based approval hierarchies that ensure operations are executed in accordance with internal business process and control requirements of the MNE. They are delegated from the top Board of Directors down the chain of command. organizational authorities can be executed across country borders as they do not create or constitute a legal commitment.

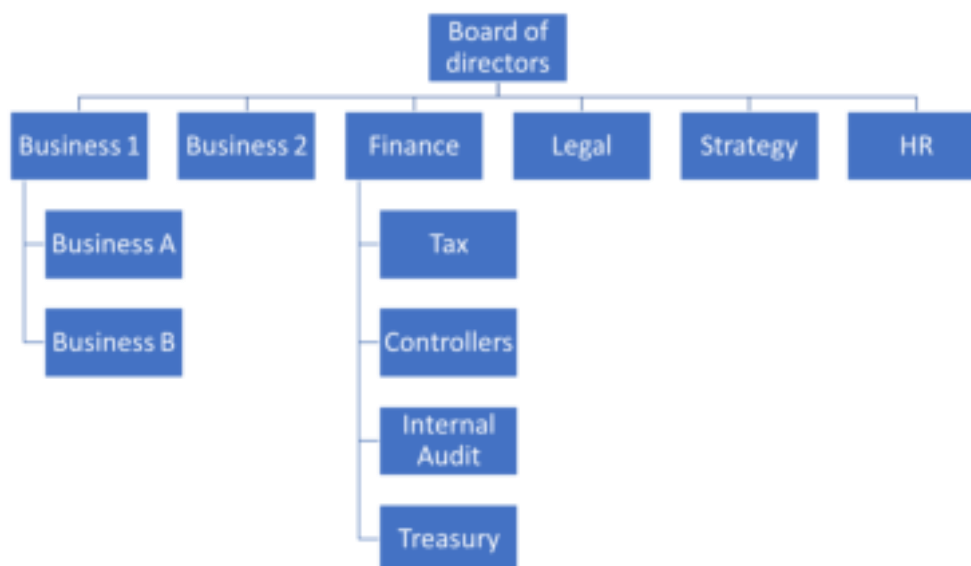
A.3.1.11. Corporate separateness is the concept of maintaining separate legal entities within the MNE group, each subsidiary having its own Board of Directors. While this does not mean that group companies must be treated as if they were wholly detached from the head office or its requests, it does mean that the boards and management of subsidiaries continue to hold fiduciary duties to control and manage the assets of, and to govern and manage the operations of, their respective subsidiaries. Organizational authorities could be considered as an advice to the separate legal entities and its boards. The corporate authorities in the end are the decision-making powers that legally bind the legal entities.

Organizational Structures

A.3.1.12. In order to be able to perform a transfer pricing analysis it is crucial to understand how the MNE is organised and what framework exists for decision-making. Ultimately an analysis of MNE decision making may provide useful context in determining risk assumption and control of important functions.

A.3.1.13. An organizational structure is used to outline how people and resources are used optimally to achieve the MNE’s objectives. Finding the ideal arrangement requires adjustments at many levels. Some organizational structures may be more rigid than others. Some may define tasks, competencies and responsibilities, and establish the patterns or relationships between positions more rigidly, while others may be more fluid. There are a number of different types of organisational structures (discussed below) including the traditional ones, functional, divisional and matrix models. However, with the rapid developments of the digitalised economy, a new organizational model is on the rise: a decentralized model based on a “network of teams”, the lateral structure.

A.3.1.14. In a **functional structure** an MNE’s functions are performed by the employees within the functional divisions. These functions are usually specialized tasks, for instance all the accountants, controllers and tax advisors are grouped together in a Finance function based on their speciality. As a whole, a functional organization is best suited to a producer of standardized goods and services at large volume and low cost to exploit economies of scale. Coordination and specialization of tasks are centralized in a functional structure, which makes decision making quicker, because the group members of a function can easily communicate as they have the same background.



Illustrative example

A.3.1.15. Under a **divisional structure**, each organizational function is grouped into a division with each division containing all the necessary resources and functions within it, such as human resources and accounts. Divisions can be categorized from different points of view. The distinction could for example be made on a geographical basis (e.g. a China division or a West Africa division) or on a product/service basis (e.g. different products for different customers: households or companies). For example, an automobile company may have a divisional structure with a division for hybrid cars and another division for other cars with each of these divisions having its own sales, engineering and marketing departments.



Illustrative example

A.3.1.16. The **matrix structure** combines elements of the functional and divisional model, and is therefore more complex. It groups people into functional departments of specialisation and then further separates them into divisions. A matrix organization frequently uses teams of

employees to accomplish tasks. An example of a function-geographic matrix structure would be a company that produces two types of products (A and B) in several geographic locations. Using the matrix structure, this company would organize functions within the company as follows:

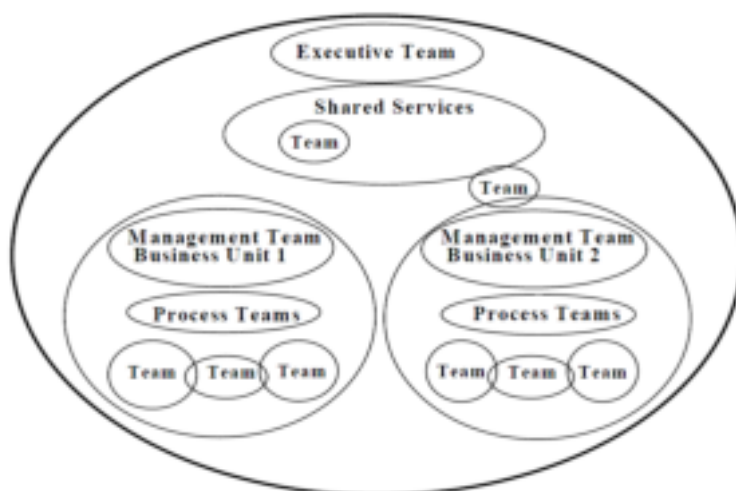


[Placeholder illustration only – similar illustration to be added]

A.3.1.17. In the **lateral structure**, which as noted above is becoming more common, MNEs build and empower teams to work on specific business projects and challenges. Groups and departments work together at the same organizational level to achieve common goals. This type of structure depends on having collaborative and informal relations and requires coordination and consultation often through a matrix model. In today’s digital economy there is a growing trend towards technology-enabled team-based lateral organization where teams can take agile decisions.¹¹

¹¹ Linda Holbeche *The Agile Organization* [.....]

**Figure 2
Team-Based Organization**



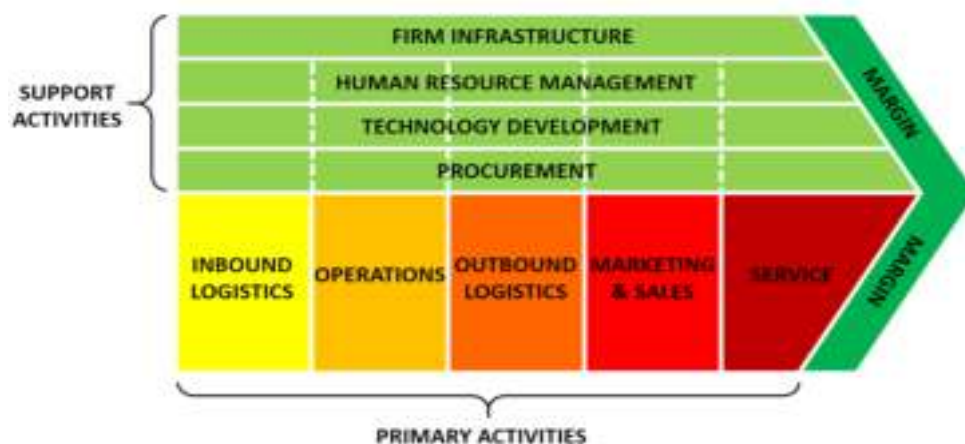
[Placeholder illustration only – similar illustration to be added]

Source : Susan A. Mohrman and Kay F. Quam, Consulting to Team Based Organisations : An Organisational Design and Learning Approach. Center for Effective Organisations.]

A.3.5. Value Chain Analysis

A.3.5.1. The aim of MNEs is to maximize profits from producing goods and services. A useful starting point to understand how an MNE operates is to perform a business value chain analysis. As noted above, a business value chain is the linked set of activities that the business performs to create value. These activities will be performed by various organisational units within the business but together, create the value that contributes to the overall profitability. As illustrated, for example, in Porter’s value chain:¹²

Placeholder illustration - following Porter’s Value Chain Analysis similar to the following:



¹² Michael Porter, *Competitive Advantage*, (1985) The Free Press. New York.

A.3.5.2. Therefore, a value chain analysis provides qualitative insight into a functional analysis and is important in assessing the intercompany pricing since the value chain identifies the key aspects of an organisation that create value, and hence, profits. The value chain analysis involves an investigation into the functions, assets and risks of the MNE as a whole and an evaluation of the contribution each value chain makes to the overall value of the group. Value chain analysis is not an easy task, especially for an MNE with complex function and risk matrices spread across different entities.

A.3.5.3. An MNE's value chain is fundamentally used to convert its economic resources of lower value into economic resources of higher value, which may involve the following steps:

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

A.3.5.4. The following example shows how three different MNEs could adopt different operational structures in relation to the same generic value chain. Some possible reasons or context for these structures being used are discussed further below.

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

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

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

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

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

Company 1 in Country A is an R&D company and carries out all the research and design activities in relation to the company's products. This company is similar to

Company 1 of Group A, apart from the fact that the design function is fully located in Company 1 and not partly carried out by Company 2.

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

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

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

A.3.5.5. In addition to understanding the value chain of an MNE, it is also important to understand the context in which each of the companies within the MNE contributes to the value chain, as this will ultimately be relevant in analysing the transfer pricing implications of the value chain.

A.3.5.6. For example, in MNE Group A's structure noted above (see Figure A.1 below) the same basic value chain is defined as Company 1 performing R&D, Company 2 manufacturing, and Company 3 distributing the MNE's products. On its face, then, the companies appear to be performing the same functions, but you need to do a deeper analysis to understand whether they are indeed the same. The context in which these activities are performed may be different depending on the legal and contractual arrangements between the companies.

A.3.5.7. One possible context could be that Company 1 performs R&D at its own risk, and is the legal owner of any intangible property developed through that R&D; Company 2 acts as a limited-risk contract manufacturer through a contractual arrangement with Company 1, and Company 3 acts as a limited-risk distributor through a contractual arrangement with Company 1. In this case, Company 1 is the legal owner of the intangible property of the MNE, and bears substantial risk associated with the manufacturing and sales of the MNE's products.

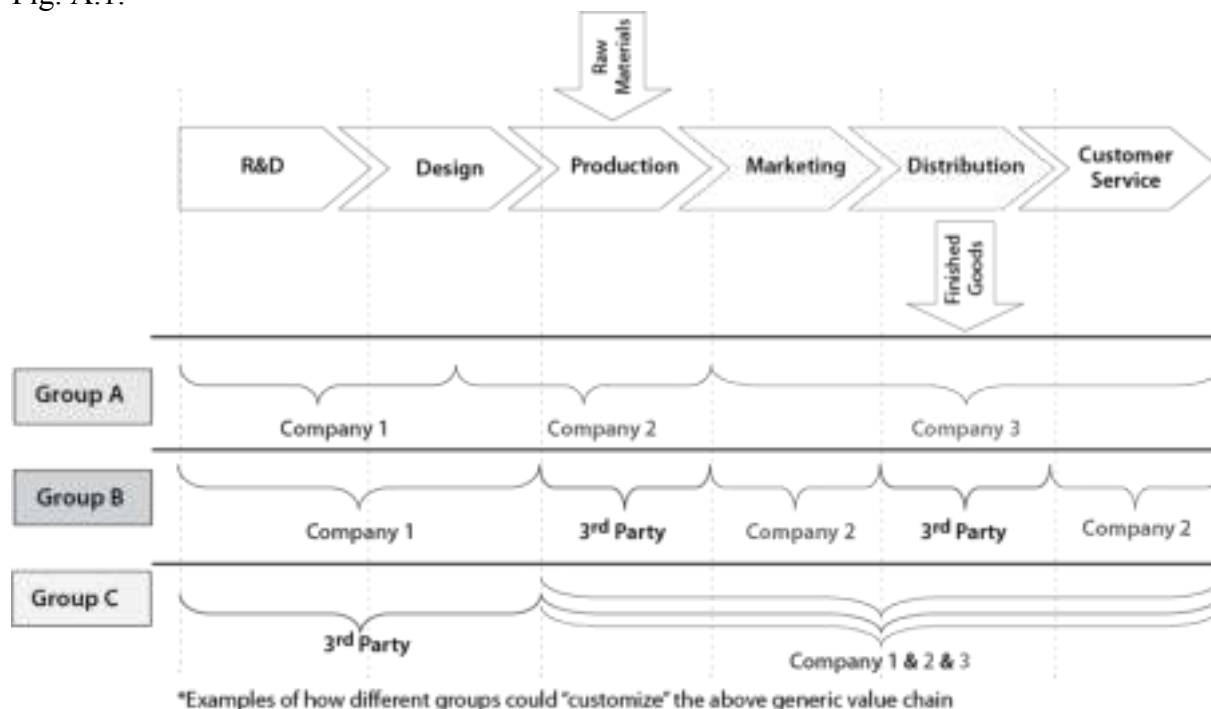
A.3.5.8. A different possible context for exactly the same basic value chain could be that Company 1 performs R&D on a contract basis for Company 2, which is the legal owner of any intangible property developed through that R&D; and Company 3 acts as a limited risk distributor through a contractual arrangement with Company 2. In this case, Company 2 is the legal owner of the intangible property of the MNE, and bears substantial risk associated with the manufacturing and sales of the MNE's products.

A.3.5.9. A different possible structure relating to the same basic value chain could be that Company 1 performs R&D on a contract basis for Company 3, which is the legal owner of any intangible property developed through that R&D; and Company 2 acts as a limited risk contract manufacturer through a contractual arrangement with Company 3. In this case, Company 3 is the legal owner of the intangible property of the MNE, and bears substantial risk associated with the manufacturing and sales of the MNE's products.

A.3.5.10. As will be discussed in subsequent chapters, each of these different contexts would very likely result in different transfer pricing outcomes.¹³

¹³ Contractual arrangements are not simply taken at face value by tax authorities. For example, each of these different possible contexts of MNE Group A's value chain would be subject to evaluation to ensure that the

Fig. A.1.



Placeholder illustration for archetype MNE business models

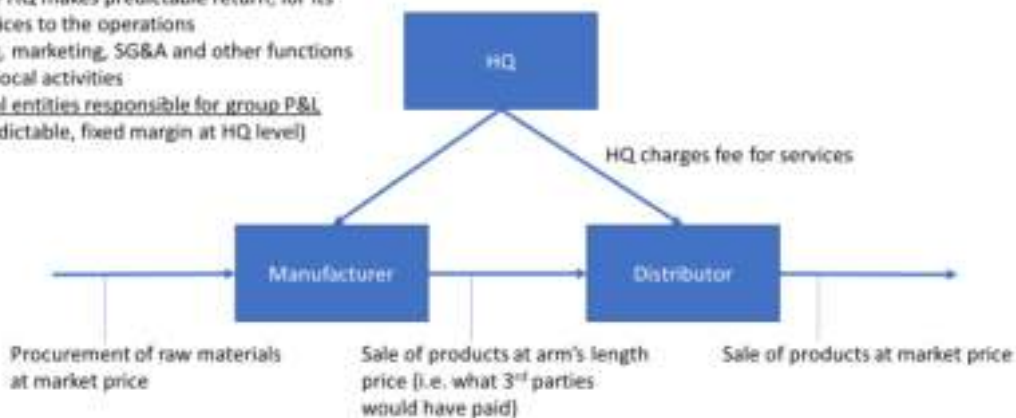
A.3.5.11. Broadly speaking, MNEs business models range from decentralized to centralized. There is no “one size fits all” solution. Under a decentralized model, all separate business units (or legal entities) are self-contained, and they typically only rely on limited services from the head office. In such a model, local sales departments will be responsible for the full range of sales activities, from business planning, marketing, customer acquisition, sales and after sales, warehousing and distribution. All risks associated with the sales, including market risks and credit risks, will be assumed by the local sales company.

A.3.5.12. The head office, in these models, generally provides “steerage” at the level of a high level, strategic direction. Similarly, local manufacturing departments will be responsible for selecting raw materials, inventory management, facility maintenance and optimization, running the plant, and selling the manufactured products to the entities performing the sales function. Entities often perform multiple functions, such as manufacturing, sales, marketing, R&D and supporting functions.

economic substance of the arrangements is consistent with the legal form of the arrangements, and that the terms of the arrangements are at arm’s length.

Example of a decentralised business model

- Negotiated price between manufacturer and distributor, based on arm's length evidence
- Manufacturer and Distributor largely run as autonomous businesses (in reality, often in same legal entity)
- Only HQ makes predictable return, for its services to the operations
- R&D, marketing, SG&A and other functions are local activities
- Local entities responsible for group P&L (predictable, fixed margin at HQ level)

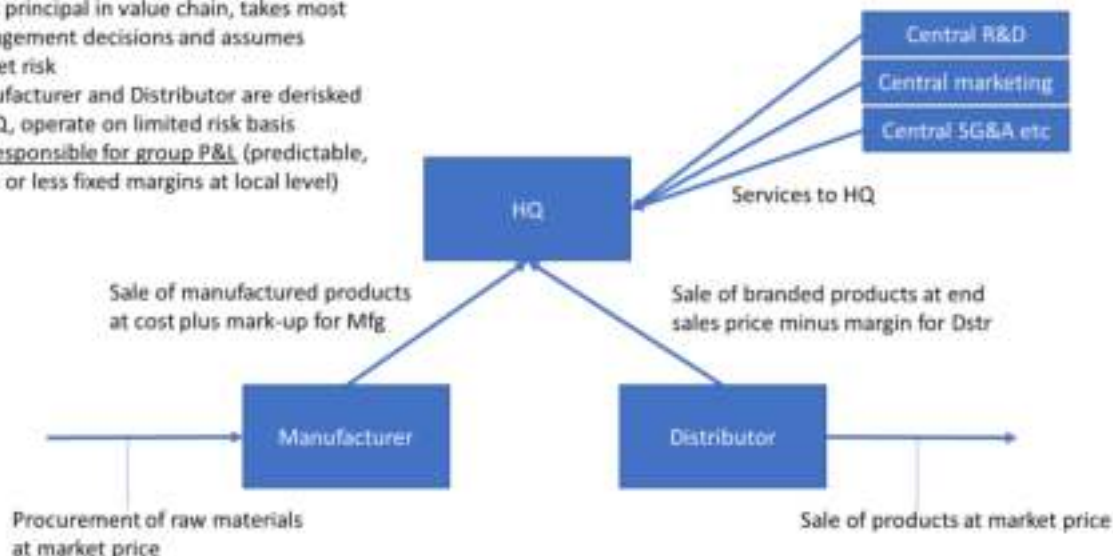


Placeholder illustration only

A.3.5.13. Ultimately, however, most multinationals are, to a greater or lesser degree, integrated, i.e. centralised. Under an integrated model, head office may be responsible for not just setting out the strategy, but for detailed instructions to local entities, managing R&D, marketing, centralized back office services and other areas – given them the benefit of centralizing scarce resources, capital, acting as the MNE’s “face” to the customer, and more generally. In such a model, local offices have less autonomous decision making, and fewer risks to manage.

Example of a centralised business model

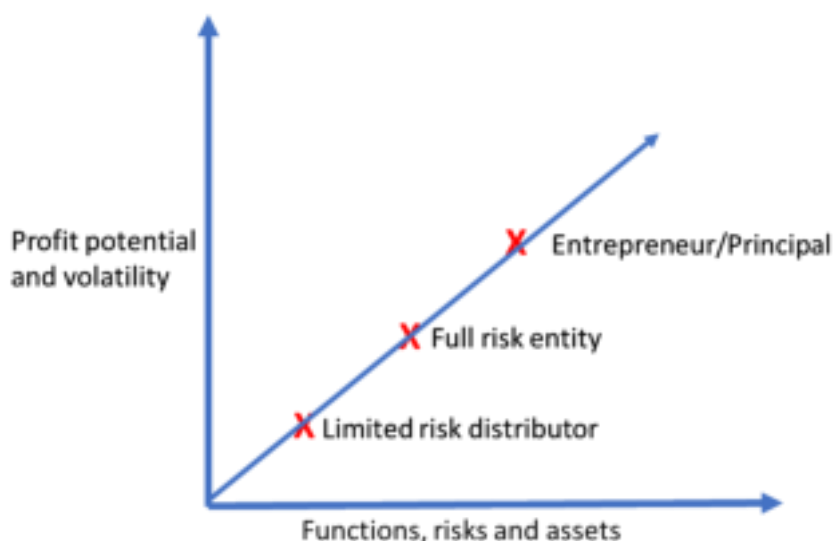
- HQ is principal in value chain, takes most management decisions and assumes market risk
- Manufacturer and Distributor are derisked by HQ, operate on limited risk basis
- HQ responsible for group P&L (predictable, more or less fixed margins at local level)



Placeholder illustration only

A.3.5.14. Another perspective for assessing an MNE’s business model is to look at each entity’s functions, assets and risks, performing this evaluation from the simpler entities to the more complex. A complex entity may own, manage and develop intellectual property and make key strategic decisions. A simpler entity would normally undertake more routine tasks with lower risk such as contract manufacturing or support service provision.

A.3.5.15. In practise there are a number of typical examples, or archetypes for sales functions, manufacturing activities and support functions. Depending on the type of activities and the level of risks the spectrum of the function and its profit potential may vary. The diagram below depicts a number of archetypes.



A.3.5.16. Within the sales function in general a number of archetypes can be identified. At one end of the spectrum is the example of a sales support service with at the other end a full risk distributor. In between these examples there are different models possible such as: sales agent/commissionaire, limited risk distributor or licensed distributor (moving along the value chain from low to high). A full risk distributor generally takes price and other market risks, stock risks, credit risks and may in addition license a brand or other intangible.



A.3.5.17. In the manufacturing function, different types of manufacturing operations can be identified. Terms commonly used to identify the spectrum of archetypes, increasing in terms of manufacturing function and the potential for profit, range from toll manufacturer to contract manufacturer, licensed manufacturer and ultimately the full risk manufacturer. The lowest risk entity is likely to be a toll manufacturer, although a toll manufacturer, as with the other types of manufacturers, will likely retain the risk of fixed asset investment and risks associated with sub-optimal utilisation of manufacturing capacity. In general, the entrepreneur retains title to both raw materials and goods throughout the whole manufacturing process. The entrepreneur buys the raw materials and bears all the inventory and sales risk, while the toll manufacturer is primarily responsible for the management and effective utilisation of the manufacturing site.



A.3.5.18. The following example draws upon the discussion above in a particular, but purely illustrative, context.

Fast-moving Consumer Goods

A.3.5.19. Fast-moving consumer goods (FMCG) are products that sell quickly at relatively low cost – items such as milk, confectionery, fruit and vegetables. Nearly everyone in the developed and developing world uses some form of FMCGs every day. They are the small-scale consumer purchases which are made at the kiosk, produce stand, grocery store, supermarket or warehouse outlet. FMCG have short shelf lives, so, while the profit margin on individual FMCG sales may be low, the volume of sales is expected to make up for it.

A.3.5.20. To become successful in the highly dynamic and innovative FMCG segment, a company has to be acquainted with the consumer, brands, and logistics, but also, it has to have a sound understanding of packaging and product promotion.¹⁴ Within the FMCG segment, understanding consumer needs is a key element to success. FMCG companies have to gain and maintain a deep understanding of the consumers' needs, lifestyles and spending patterns in the market targeted, as well as adapting to the evolution of consumers' shopping habits, to allow them to effectively place their product in the market.

A.3.5.21. Branding is a key element of success for FMCG companies. FMCG companies rely on marketing, communications and other techniques to establish and develop brand awareness and loyalty to their products. While superior and innovative physical packaging notably attracts the consumer and helps conveying the message of the brand in the stores, communications through different media and interactions with the consumers are also important to create awareness outside of the stores and ultimately create a desire to purchase repeatedly.

A.3.5.22. Managing input costs and manufacturing costs also remain vitally important in this business. This notably requires efficient product sourcing, input logistics strategies and innovative technology.

A.3.5.23. Another key factor in the FMCG sector is to have a predictable and trustworthy distribution channel. While some retailers opt for vertical integration (this is particularly relevant for developing countries, where distribution channels may not always be as structured as in developed countries) others outsource logistics and warehousing services to trusted third parties. Indeed, in some countries, quality logistics and warehousing services with local knowledge and expertise are increasingly available for businesses at relatively lower cost, enabling even small and medium-sized enterprises to obtain these capabilities early in their business cycle.

A.3.5.24. There are several ways an FMCG company can distribute its products to reach end-consumers, depending on the company's level of vertical integration and the number of intermediaries:

- first, the simplest distribution channel is a direct sale from manufacturers to consumers with no intermediary, often through an online store;
- second, there are distribution channels where there can be one intermediary as the middleman between the producer and consumer. An example is a brick-and-mortar

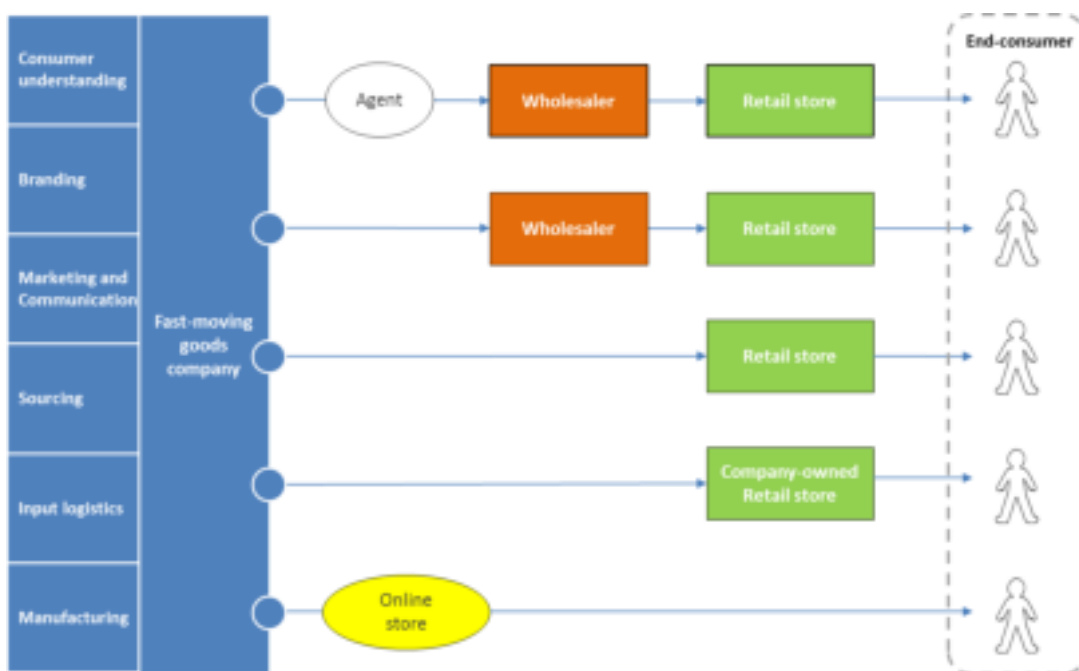
¹⁴ Shaout A., & Khalid M. "Employee performance appraisal system using Fuzzy logic". *International Journal of Computer Science and Information Technology* (6(4)): 1-19.

ATTACHMENT A: PART A – TRANSFER PRICING IN A GLOBAL ENVIRONMENT

retailer between manufacturer and consumer. This retailer can be independent or be part of the same group as the producer;

- third, the distribution channel can involve two intermediaries between producer and consumer. An example is a wholesaler selling to a retailer which then sells to the consumer; and
- finally, there are distribution channels where an agent or broker is used. Agents work on behalf of companies and deal primarily with wholesalers. From here, the wholesalers sell to retailers which then sell to consumers.

A.3.5.25. These different types of distribution channels are summarized in the following chart:



Placeholder illustration only

Example of business model in oil and gas industry:

A.3.5.26. International Oil Companies (IOCs) are investor-owned, market-oriented, and mainly aim to increase shareholder value. Various degrees of size, specialization and integration exist in IOCs. Often, companies specialize in one or more individual industry segments, such as the exploration and production, refining, transportation/distribution or marketing segments. Many of the largest multinational oil and gas companies integrate all businesses and are referred to as “vertically integrated” oil companies.¹⁵

A.3.5.27. An example of a vertical integrated oil company can be depicted as follows:



Source: Shell Annual Report 2017: Business Overview¹⁶

¹⁵ Chapter 1 United Nations Handbook on extractives industries taxation

¹⁶ Available at <https://reports.shell.com/annual-report/2017/strategic-report/strategy-business-and-market-overview/business-overview.php>

A.3.5.28. The oil and gas industry is often considered to have two major parts: the “Upstream” activities—those related to the exploration and production of crude oil and natural gas, and the “Downstream” activities—those related to the transportation, refining and marketing of oil and natural gas and their products.¹⁷

A.3.5.29. Within the two major business parts, there are often several different organizational units representing different business lines. In Upstream a distinction may be made for example between “exploration” activities and “production” activities, while in downstream there may be a trading, manufacturing or a chemicals business. In a vertically integrated IOC, the company has multiple global businesses with different business models and multiple cost centers. The size of the IOC adds to the complexity.

A.3.5.30. Each different business line can have a different business model. Certain activities can be centralized, for example service companies which provide advice and services to operating companies, i.e. technical advice or accounting services. The cost of those centralized services may be cost-shared or directly charged to an operating company. The production of oil may be completely de-centralized.

A.3.5.31. The management of each production facility is responsible for the performance and long-term viability of its own operations but can draw on the experience of service companies and through them, of other group companies. Intangibles can be owned centrally whereas R&D centers around the globe maybe doing research. Depending on the products and the manufacturing sites, different models may be used ranging from contract manufacturing to toll-manufacturing models. And finally, once products are sold to the market, all typical sales functions can be identified: buy-sell distributors, licensed distributors, direct sales, in-market service companies etc.

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

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

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

A.4.3. Financial reporting for MNEs is informed by two decision trees. On the one hand, corporate and tax law require an associated enterprise to determine its taxable income derived

¹⁷ Sometimes the term “midstream” is also used – for example: “[a]ctivities connecting the pure upstream and downstream functions are sometimes referred to as “midstream,” and consist of trading and transportation (by pipeline, rail, barge, tanker or truck) storage, and wholesale marketing of crude oil, natural gas or refined petroleum products” - *United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries* (2017) at page 15. The distinction is not necessary for purposes of this discussion, however.

from a specific jurisdiction. On the other hand, an MNE will usually need to determine for management purposes the income and costs of its business lines, which, as the previous discussion shows, can operate across several jurisdictions. In other words, while tax authorities focus on an associated enterprise's taxable income, an MNE's managers focus on income from their business lines. MNEs should develop and publicize within the enterprise a global transfer pricing policy to help minimize the risk of transfer pricing adjustments which may result in double taxation.

A.4.4. The allocation of profits and costs to the various legal structures is based on the functions performed, assets employed and risks assumed (so-called "FAR analysis"). Since MNEs consist of numerous associated enterprises it is very difficult to allocate the profits and costs to all the separate legal entities, especially due to the absence of market forces. It is a complex exercise to come up with a consistent and coherent global policy for allocating results to the legal structures.

A.4.5. The arm's length principle allows national tax authorities to make an adjustment to the profits of one enterprise where the terms of transactions between associated enterprises differ from terms that would be agreed between unrelated enterprises in similar circumstances. If the terms of a transaction between associated enterprises differ from those between unrelated parties and comparisons are difficult to make, an MNE bears the risk of transfer pricing adjustments. If the income of an associated enterprise within Country A is increased as a result of a transfer pricing adjustment, it would be reasonable to expect that there would be a corresponding transfer pricing adjustment resulting in a proportionate reduction in the income of the other associated enterprise in Country B provided a consistent transfer pricing evaluation is made by both countries.

A.4.6. However, if the tax authority of Country A makes a transfer pricing adjustment double taxation will occur if the tax authority of Country B does not agree with the adjustment and does not allow a corresponding transfer pricing adjustment. The risk is of "economic" double taxation, where two different legal entities are essentially taxed on the same profits. It is the task of the transfer pricing function within an MNE to limit the risk of transfer pricing adjustments and the risk of double taxation. See the illustration of double taxation below in Figure A.3.

[Illustration to be added – visual representation of (economic) double taxation.]

A.4.7. In principle, designing, implementing and documenting an appropriate transfer pricing policy should not be viewed solely as a compliance issue for MNEs. The main goal should be to develop a consistent and principles-based global policy. A well-developed and consistently applied transfer pricing policy should reduce an MNE's risk of transfer pricing adjustments and the potential for double taxation, thereby increasing profitability by minimizing transfer pricing costs. Moreover, a global transfer pricing policy may be used as evidence in negotiations with tax authorities when transfer pricing disputes occur.

A.4.8. An MNE's transfer pricing policy should ideally reduce the risk of transfer pricing adjustments and the risks of double taxation of cross-border transactions. A comprehensive transfer pricing policy should cover four key areas.

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

A.4.9. **Advising** requires a thorough knowledge of an MNE’s business operations. It is a common misconception that the tax department makes the key business decisions within an MNE. In practice, the business units of an MNE will identify business opportunities and a decision may be taken to exploit the opportunity if it fits within the MNE’s global business strategy. Advice can be provided to minimize the risk of transfer pricing adjustments and therefore optimize the business opportunity if the tax department is involved in an MNE’s decision-making.

A.4.10. In today’s environment there is an increasing level of detail required to meet each country’s transfer pricing documentation requirements. Most MNEs therefore prepare global and regional documentation (master files) of the various global businesses. Subsequently, global and regional reports are prepared for local purposes (local files) based on the identified risks for each country in which the MNE operates.

A.4.11. Tax authorities around the world are increasingly focussed on transfer pricing and on expanding their transfer pricing capabilities. MNEs have to find a way to deal with the increasingly detailed, complex and often conflicting domestic transfer pricing legislation in the countries where they operate. Some countries closely follow guidance from international bodies, others only implement part of the guidance while some develop transfer pricing rules independently.

A.4.12. It should not be generally assumed that MNEs are not complying with transfer pricing rules in order to obtain tax benefits. Corporate management is under pressure to control corporate costs including tax costs but many MNEs, especially those with shares quoted on a stock exchange (listed MNEs), may have published codes of conduct or a set of business principles or both. Some of these codes or principles may explicitly require that an MNE must comply with the tax rules of the countries in which they operate. Violations of some of these codes may result in severe consequences for a listed MNE but they should not be seen as a guarantee that there may not be a disagreement about the proper application of the transfer pricing rules.

A.4.13. As transfer pricing is often referred to as “an art, not a science”, the resulting uncertainty creates the potential for transfer pricing disputes with tax authorities, even if the MNE is seeking to comply with domestic transfer pricing rules. Even where MNEs may invest in setting the appropriate transfer prices and preparing comprehensive documentation, there is always the risk that tax authorities disagree with the approach taken and there is thus the risk of a transfer pricing adjustment. This creates uncertainty for MNEs including the potential associated costs of preparing additional documentation, managing tax audits and conducting litigation. Notwithstanding this, there are cases where transfer prices are manipulated to shift profits from one jurisdiction to another to gain tax benefits including low taxation or no taxation.

A.4.14. Transfer pricing rules are considered very useful by MNEs if they are able to achieve a globally consistent approach and eliminate the risk of transfer pricing disputes. If in one country an MNE’s transfer prices are adjusted, resulting in a higher taxable income, the associated enterprise in the other country should in principle¹⁸ receive a “corresponding adjustment”, reducing its taxable income. If there is no corresponding adjustment, the MNE will suffer double taxation. In this situation, the dispute is between two tax authorities with the MNE seeking to have consistent transfer prices accepted by both countries.

¹⁸ UN and OECD Model Tax Conventions, Article 9 (Associated Enterprises).

A.4.15. Countries should try to avoid such double taxation, though in some cases there may be legitimate reasons why a corresponding adjustment is not given, or is less than the original adjustment. In such a case, where a double taxation treaty is in place, it is important that the two countries enter into discussions to resolve the double taxation issue under the mutual agreement procedure mechanism as described in that treaty.

This Part was first considered at the 20th session and is for final approval at the 21st Session

PART B: DESIGN PRINCIPLES AND POLICY CONSIDERATIONS

B.1. Introduction to Transfer Pricing

B.1.1. What is Transfer Pricing?

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

B.1.1.2. A significant volume of global trade consists of international transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within an MNE group; such transfers are called “intragroup transactions”. There is evidence that intragroup trade has been growing steadily since the mid-20th century and arguably accounts for more than 30 per cent of all international transactions.

B.1.1.3. In addition, transactions involving intangibles and multi-tiered services constitute a rapidly growing proportion of an MNE’s commercial transactions and have greatly increased the complexities involved in analysing and understanding such transactions.

B.1.1.4. The structure of transactions within an MNE group¹ is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. A large and growing number of intragroup transactions may therefore not be governed entirely by market forces, but will largely be driven by the common interests of the entities of a group.

B.1.1.5. In such a situation, it becomes important to establish the appropriate price, called the “transfer price”, for intragroup transfers of goods, intangibles and services. “Transfer pricing” is the general term for the pricing of transactions between related parties. Transfer pricing therefore refers to the setting of prices² for transactions between associated enterprises involving the transfer of property or services. These transactions are also referred to as “controlled” transactions, as distinct from “uncontrolled” transactions between persons that are not associated with each other and can be assumed to operate independently (“on an arm’s length basis”) in setting terms for such transactions.

B.1.1.6. Transfer pricing thus does not necessarily involve tax avoidance, as the need to set such prices is a normal aspect of how MNEs must operate. Where the pricing does not accord with internationally applicable norms or with the arm’s length principle under domestic law, the tax administration may consider this to be “mis-pricing”, “incorrect pricing”, “unjustified

¹ For transfer pricing purposes, the component parts of an MNE group, such as companies, are called “associated enterprises”.

² However, in most cases the transfer pricing analysis will end after an appropriate profit margin has been determined. See Chapter B.3 on Transfer Pricing Methods.

ATTACHMENT B.1. - INTRODUCTION TO TRANSFER PRICING

pricing” or non-arm’s length pricing, and issues of tax avoidance and evasion may potentially arise. The following examples illustrate these points:

Example 1: Solid State Drive Manufacturer

- The X Group is in the business of selling computers. The group as a whole is profit making. The parent company, located in Country A, buys “solid state drives” from its subsidiary in Country B. The price the parent company in Country A pays its subsidiary company in Country B (the “transfer price”) will determine how much profit the subsidiary reports in Country B and how much local income tax it pays. If the parent company pays the subsidiary a price that is lower than the appropriate arm’s length price, the subsidiary may appear to be in financial difficulty, even if the group as a whole shows a reasonable profit margin when the completed computer is sold.
- Country A’s tax authorities might agree with the profit reported at their end by the parent company, but their Country B counterparts may not agree — they may not have the expected profit to tax on their side of the operation. If the parent company in Country A had purchased its drives from an independent company in Country B under comparable circumstances, it would pay the market price, and the supplier would pay taxes on its own profits in the normal way. From this analysis, and assuming the Country A’s income tax rate is lower than Country B’s, the fact that higher profits will be reported in Country A may result in the presumption that the transfer price was fixed at below arm’s length amount in order to minimize the group’s income tax incidence.
- Accordingly, when the various parts of the organization are under some form of common control, it may mean that transfer prices are not subject to the full play of market forces and the correct arm’s length price, or at least an “arm’s length range” of prices, needs to be arrived at.

Example 2: Luxury Watch Manufacturer

- A luxury watch manufacturer in Country A distributes its watches through a subsidiary in Country B. It is assumed that the watch costs \$1400 to make and it costs the Country B subsidiary \$100 to distribute it. The company in Country A sets a transfer price of \$1500 and the subsidiary in Country B retails the watch at \$1600 in Country B. Overall, the company has thus made \$100 in profit, on which it is expected to pay tax.
- However, when the subsidiary is audited by Country B’s tax authorities they notice that the distributor itself does not earn a profit: the \$1500 transfer price plus the distributor’s \$100 distribution costs are exactly equal to the \$1600 retail price. Country B’s tax authorities consider that the transfer price should be set at \$1400 so that the distributor can make a profit (in this case \$100) that would be liable for tax in Country B.
- This poses a problem for the parent company, as it is already paying tax in Country A on the \$100 profit per watch shown in its accounts.

- Since it is a multinational group it is liable for tax in the countries where it operates, hence the MNE can end up suffering double taxation on the same profits where there are differences about what constitutes the appropriate transfer price.

B.1.17. A possible reason for associated entities charging transfer prices for intragroup trade is to measure the performance of the individual entities in a multinational group. The individual entities within a multinational group may be separate profit centres and transfer prices are required to determine the profitability of the entities. However, not every entity would necessarily make a profit or loss under arm's length conditions. Rationally, an entity having a view to its own interests as a distinct legal entity would only acquire products or services from an associated entity if the purchase price was equal to, or cheaper than, prices being charged by unrelated suppliers. This principle applies, conversely, in relation to an entity providing a product or service; it would rationally only sell products or services to an associated entity if the sale price was equal to, or higher than, prices paid by unrelated purchasers. On this basis prices should gravitate towards the "arm's length price", i.e. the price that would be agreed upon between unrelated parties in similar circumstances.

B.1.1.8. While the above explanation of transfer pricing sounds logical and simple enough, arriving at an appropriate transfer price may be a complex task particularly because of the difficulties encountered in respect of certain transactions, e.g., in identifying and valuing intangibles transferred and/or services provided. For example, intangibles could be of various different types such as industrial assets like patents, trade names, designs or models, literary and artistic property rights, know-how or trade secrets, which may or may not be reflected in the accounts. There are thus many complexities involved in dealing with transfer pricing in cross-border transactions between MNE entities.

B.1.1.9. Transfer pricing is a term that is also used in economics, so it is useful to see how economists define it. In business economics a transfer price is considered to be the amount that is charged by a part or segment of an organization for a product, asset or service that it supplies to another part or segment of the same organization. This definition is therefore consistent with the approach described above.

B.1.2. Basic Issues Underlying Transfer Pricing

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

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

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

B.1.2.4. An added dimension to the jurisdictional issue is that of the motivation for transfer pricing manipulation, as some MNEs engage in practices that seek to reduce their overall tax

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bills. This may involve profit shifting through non-arm's length transfer pricing in order to reduce the aggregate tax burden of the MNE. However, while reduction of taxes may be a motive influencing the MNE in setting transfer prices for intragroup transactions, it is not the only factor that determines transfer pricing policies and practices.

B.1.2.5. The aim of non-arm's length transfer pricing in such cases is usually to reduce an MNE's worldwide taxes. This can be achieved by shifting profits from associated entities in higher tax countries to associated entities in relatively lower tax countries through either undercharging or overcharging the associated entity for intragroup trade. For example, if the parent company in an MNE group has a tax rate in the residence country of 30 per cent, and has a subsidiary resident in another country with a tax rate of 20 per cent, the parent may have an incentive to shift profits to its subsidiary to reduce its tax rate on these amounts from 30 per cent to 20 per cent. This may be achieved by the parent being overcharged for the acquisition of property and services from its subsidiary.

B.1.2.6. While the most obvious motivation may be to reduce the MNE's global effective tax rate, other factors may influence transfer pricing decisions, such as imputation of tax benefits in the parent company's country of residence.

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

B.1.2.8. MNEs are global structures which may share common resources and overheads. From the perspective of the MNE these resources need to be allocated with maximum efficiency in an optimal manner.

B.1.2.9. From the government's perspective, the allocation of costs and income from the MNE's resources is an essential element in calculating the tax payable. There can thus be a dispute between countries in the allocation of costs and resources, owing to their objective of maximizing the tax base in their respective jurisdictions.

B.1.2.10. From the MNE's perspective, any trade or taxation barriers in the countries in which it operates raise the MNE's transaction costs while distorting the allocation of resources. Furthermore, many of the common resources which are a source of competitive advantage to an MNE cannot be separated from the income of the MNE's group members for tax purposes. This is especially true in the case of intangibles and service-related intragroup transactions.

B.1.2.11. Mere allocation of income and expenses to one or more members of the MNE group is not sufficient; the income and expenses must also be *valued*. A key issue of transfer pricing is therefore the valuation of intragroup transfers.

B.1.2.12. As MNEs are integrated structures with the ability to exploit international differentials and to utilize economies of integration not available to stand-alone entities, transfer prices within the group may not always be the prices that unrelated parties would negotiate.

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B.1.2.13. International tax issues, especially transfer pricing related issues, throw open a number of challenges, the complexity and magnitude of which are often especially daunting for tax administrations with limited capacity or experience to deal with such issues.

B.1.2.14. One such complex yet pressing issue, especially given the exponential rise of the digital economy, is arriving at the appropriate arm's length price for transactions involving intangibles. Intangibles are often unique, mobile and difficult to value and this presents unique problems for taxpayers and tax authorities alike.

B.1.2.15. Transfer pricing issues related to business restructuring and intragroup services also present special challenges. Transfer pricing documentation requirements for MNEs continues to be a key focus area given the evolution of stringent documentation standards, including country-by-country reporting, not to mention the increasing information exchange between governments on international transactions.

B.1.2.16. All these basic and critical transfer pricing issues are addressed in detail in this Manual in separate chapters.

B.1.2.17. Overall, it should be amply clear that transfer pricing rules are essential for countries in order to protect their tax base, to eliminate double taxation and to enhance cross-border trade. For developing countries, transfer pricing rules are essential to provide a climate of certainty and an environment for increased cross-border trade while at the same time ensuring that the country is not losing out on critical tax revenue. Transfer pricing is thus of paramount importance and hence detailed transfer pricing rules are essential.

B.1.3. Evolution of Transfer Pricing

B.1.3.1. This section aims to trace the history and the reasons for transfer pricing taxation regimes. It is important to note that transfer pricing essentially involves the application of economic principles to a fluid marketplace. Thus new approaches and techniques that help arrive at the appropriate transfer price from the perspective of one or more factors in the system continue to be developed.

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

B.1.3.3. Special attention must be focused on the meaning and scope of the term "associated enterprises", which is a topic of importance but one not defined or discussed adequately so far. This issue is discussed in more detail in ****.

B.1.3.4. From a financial perspective, transfer pricing is probably the most important cross-border tax issue globally. This is partly because the term "MNE" not only covers large corporate groups but also smaller groups with one or more subsidiaries or permanent establishments (PEs) in countries other than those where the parent company or head office is located.

B.1.3.5. Parent companies of large MNE groups usually have intermediary or sub-holdings in several countries around the world. From a management perspective, the decision-making in MNE groups may range from highly centralized structures to highly decentralized structures with profit responsibility allocated to individual group members. Such group structures typically include:

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

B.1.3.6. The ongoing and continuous relocation of the production of components and finished products to particular countries; the rise of many new economies in the developing countries with their infrastructure, skilled labour, low production costs, conducive economic climate etc.; the round-the-clock trading in financial instruments and commodities; and the rise of e-commerce and Internet-based business models are a few of the many reasons why transfer pricing has become such a high profile issue over the past couple of decades.

B.1.3.7. Other considerations have also had an impact on the importance of transfer pricing. Some developed countries have tightened their transfer pricing legislation to address the issue of foreign enterprises active in their countries paying lower tax than comparable domestic groups. Consequently, some developing countries have introduced equally exhaustive transfer pricing regulations in their countries to keep their tax bases intact. Other developing countries are recognizing that they need to effectively address the challenges of transfer pricing in some way.

B.1.3.8. Countries with less sophisticated tax systems and administrations have run the risk of absorbing the effect of stronger enforcement of transfer pricing in developed countries and in effect paying at least some of the MNEs’ tax costs in those countries. In order to avoid this, many countries have introduced transfer pricing rules.

B.1.3.9. The G20/OECD Base Erosion and Profit Shifting (BEPS) Project resulted in the release, in 2015, of final reports on measures based on 15 Action Plans. Among other things, the Action Plans provide model provisions to prevent treaty abuse; call for standardized country-by-country reporting in terms of documentation requirements; elucidate a peer review process for addressing harmful tax practices; endorse a minimum standard to secure progress on dispute resolution and make many other such recommendations.

B.1.3.10. While the OECD BEPS initiative, theoretically, is aimed at revamping international tax standards to keep pace with the changing global business environment, the practical implementation of such BEPS measures is dependent on the individual countries making necessary changes to their domestic laws as well as modifying treaty provisions with other countries and doing all of this in a coordinated manner. Towards accomplishing this objective, the OECD/G20 Inclusive Framework on BEPS, with a global membership including about 70% of non-OECD and non-G20 countries from all geographic regions, was set up in 2016. The members of the Inclusive Framework are collaborating on the implementation of the 15 measures to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment.⁴

B.1.3.11. The OECD TP Guidelines have emerged from Article 9 of the OECD Model Convention; they have also been applied in the context of the UN Model Double Tax Convention. There are presently five transfer pricing methods (see Chapter B.3.) that may be

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

⁴ For further details, see <https://www.oecd.org/tax/beps/about/>

used in various situations to arrive at an arm's length price. However, while these methods may be able to provide a computation of the arm's length price (i.e. an appropriate transfer price) within the MNE, in practice disagreements between tax authorities in applying these methods may result in taxable profits between two MNEs being either more than 100 per cent or less than 100 per cent of actual combined profits. This situation could arise as a result of adjustments carried out by one tax authority without corresponding adjustments by the tax authority in the other country, for example, where such adjustments are not endorsed in the relevant double taxation treaty.

B.1.4. The Arm's Length Principle in Transfer Pricing

B.1.4.1. The UN Model Tax Convention Article 9(1) states the following:

“Where:

- (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of these conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly”.⁵

B.1.4.2. In other words, the transactions between two related parties should reflect the outcome that would have been achieved if the parties were not related i.e. if the parties were independent of each other and the outcome (price or margins) was determined by (open) market forces. This is the basis of the “arm's length principle”. The principle set out above in the UN Model has also been reiterated in the OECD Model Tax Convention and the OECD Guidelines as supplemented and amended.

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

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

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

⁵ United Nations, New York 2011. Available from http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf.

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B.1.4.6. Article 9(2) of the UN Model also requires that when the tax authorities of a Contracting State make a transfer pricing adjustment to reflect the application of the arm's length principle to the taxpayer's related party transactions, the other Contracting State should make an appropriate "corresponding adjustment" in order to avoid double taxation. The competent authorities⁶ of the Contracting States are if necessary to consult with each other in determining the adjustment.

[to be renumbered]B.1.4.7. The UN Model contains provisions (Article 9(3)) which stipulate that a Contracting State is not required to make the corresponding adjustment referred to in Article 9(2) where judicial, administrative or other legal proceedings have resulted in a final ruling that, by the actions giving rise to an adjustment of profits under Article 9(1), one of the enterprises concerned is liable to a penalty with respect to fraud, or to gross or wilful default.

[B.1.4.8. An argument in favour of using the arm's length principle is that it is geographically neutral, as it treats profits from investments in different places in a similar manner. However, this claim of neutrality is conditional on consistent rules and administration of the arm's length principle throughout the jurisdictions in which an international enterprise operates. In the absence of consistent rules and administration, international enterprises may have an incentive to avoid taxation through transfer pricing manipulation.

B.1.4.9. While it is relatively easy to describe the arm's length principle, establishing guidelines on the practical application of the principle is a complex task. Practical application of the principle requires identification of reliable comparable transactions.

B.1.4.10. The example below illustrates a situation where the arm's length principle needs to be applied:

Example: Automobile Seat Manufacturer

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

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

Based on these facts, it is seen that when associated enterprises deal with each other their commercial or financial relations may not be directly affected by market forces but may be influenced more by other considerations (*see* caution in B.1.4.11.). The arm's length principle therefore seeks to determine whether the transactions between related taxpayers (in this case Corporation P and its Subsidiary S) are appropriately priced to reflect their true tax liability by comparing them to similar transactions between unrelated taxpayers at arm's length.

⁶ Officials designated by countries to discuss treaty and other international tax-related issues with each other.

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B.1.4.11. Intangibles present a unique challenge when applying the arm's length principle mainly due to the fact that in practice intangibles may be difficult to identify, value and find comparables for.

B.1.4.12. In practice, various factors can affect the arm's length price. These factors range from government policies and regulations to cash flows of the entities in the MNE group.

B.1.4.13. There should not be an implicit assumption on the part of the tax authorities that there is profit manipulation by the MNE simply because there is an adjustment to approximate the arm's length transaction; any such adjustment may arise irrespective of the contractual terms between the entities. Another incorrect assumption, sometimes made in practice, is that the commercial or financial relations between associated enterprises and in the marketplace will always be different and at odds with each other.

B.1.4.14. In many cases the MNEs themselves may have an incentive to set an arm's length price for their intragroup transactions so as to judge the true performance of their underlying entities.

B.1.4.15. Overall, the underlying idea behind the arm's length principle is the attempt to place transactions, both uncontrolled and controlled, on equal terms with respect to the tax advantages (or disadvantages) that they create. The arm's length principle has been widely accepted and has found its way into most transfer pricing legislation across the world.

B.1.4.16. The practical application of the arm's length principle typically involves the following processes or steps, and considerations, among others:

- Comparability analysis;
- Evaluation of transactions;
- Evaluation of separate and combined transactions;
- Use of an arm's length range or a central point in the range;
- Use of multiple year data;
- Losses;
- Location savings and location rents;
- Intentional set-offs; and
- Use of customs valuation.

B.1.4.17. The above processes are discussed in detail in Chapter B.2. of this Manual on Comparability Analysis.

B.1.4.18. The transfer pricing methods are dealt with comprehensively in Chapter B.3. It is, however, important to note at the outset that there is no single transfer pricing method which is generally applicable in every possible situation.

B.1.4.19. Computing an arm's length price using transfer pricing analysis is a complex task. The task requires effort and goodwill from both the taxpayer and the tax authorities in terms of documentation, groundwork, analysis and research; comparables play a critical role. This Manual seeks to assist developing countries in that task as much as possible, but it has to be recognized that the task will rarely be a simple one. The issue of lack of comparables is explored further in Chapter B.2. of this Manual on Comparability Analysis.

B.1.4.20. An alternative to the arm's length principle might be a Global Formulary Apportionment Method, which would allocate the global profits of an MNE group among the associated enterprises on the basis of a multi-factor weighted formula (using factors such as property, payroll and sales for example, or such other factors as may be defined when adopting

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the formula). A formulary apportionment approach is currently used by some states of the USA, cantons of Switzerland and provinces of Canada. The EU is also considering an optional formulary approach to harmonize its corporate taxes under the Common Consolidated Corporate Tax Base (CCCTB) initiative.

B.1.5. Transfer Pricing as a Current and Future Issue

General issues with transfer pricing

B.1.5.1. Several issues arise when applying the arm's length principle to the domestic realities of developing countries. The high level of integration of international enterprises, the proliferation of intragroup trading in intangibles and services and the use of sophisticated financing arrangements have increasingly made the arm's length principle difficult to apply in practice.

B.1.5.2. Increasing globalization, sophisticated communication systems and information technology allow an MNE to control the operations of its various subsidiaries from one or two locations worldwide. Trade between associated enterprises often involves intangibles. The nature of the world on which international tax principles are based has changed significantly. All these issues raise challenges in applying the arm's length concept to the globalized and integrated operations of international enterprises. Overall, it is clear that in the 21st century the arm's length principle presents real challenges in allocating the income of highly integrated international enterprises. Part A of this Manual puts this issue in perspective by discussing some of the forms and structures used by international enterprises to carry out business in an ever changing global environment.

B.1.5.3. It is widely accepted that transfer pricing is not an exact science and that the application of transfer pricing methods requires the application of information, skill and judgement by both taxpayers and tax authorities. In view of the skill, information and resource "gaps" in many developing countries, this can be very difficult for those developing countries; the task often requires the best officials, who may leave the tax department after acquiring their special skills. The intention of this Manual is to play a part in reducing those gaps.

Transfer pricing and developing countries

B.1.5.4. For all countries, but particularly for many developing countries, equipping an administration to deal fairly and effectively with transfer pricing issues seems to be a "taxing exercise", both literally and figuratively.

B.1.5.5. Some of the specific challenges that many developing countries particularly face in dealing effectively with transfer pricing issues (and which will be dealt with in more detail later in this Manual) are listed below.

Lack of comparables

B.1.5.6. One of the foundations of the arm's length principle is examining the pricing of comparable transactions. Proper comparability is often difficult to achieve in practice, a factor which in the view of many weakens the continued validity of the principle itself. The fact is that the transfer pricing methods directly rely on comparables (see chapter B.3.). It is often extremely difficult in practice, especially in some developing countries, to obtain adequate information to apply the arm's length principle for the following reasons:

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- There tend to be fewer organized operators in any given sector in developing countries; thus finding proper comparable data can be very difficult;
- The comparable information in developing countries may be incomplete and in a form which is difficult to analyse, as the resources and processes are not available. In the worst case, information about an independent enterprise may simply not exist. Databases relied on in transfer pricing analysis tend to focus on developed country data that may not be relevant to developing country markets (at least without resource and information-intensive adjustments), and in any event are usually very costly to access; and
- Transition countries whose economies have just opened up or are in the process of opening up may have “first mover” companies who have come into existence in many of the sectors and areas hitherto unexploited or unexplored; in such cases there would be an inevitable lack of comparables.

B.1.5.7. Given these issues, critics of the current transfer pricing methods equate finding a satisfactory comparable to finding a needle in a haystack. Overall, it is quite clear that finding appropriate comparables in developing countries for analysis is quite possibly the biggest practical problem currently faced by enterprises and tax authorities alike, but the aim of this Manual is to assist that process in a practical way. The Toolkit jointly produced by the IMF, OECD, UN and World Bank⁷ provides additional guidance on this issue. Chapter B.2. of this Manual provides analysis and practical examples on Comparability Analysis.

Lack of knowledge and requisite skill sets

B.1.5.8. Transfer pricing analysis is complex and time-consuming, often requiring time and attention from some of the most skilled and valuable human resources in both MNEs and tax administrations. Transfer pricing reports often run into hundreds of pages with many legal and accounting experts employed to create them. This kind of complexity and knowledge requirement puts tremendous strain on both the tax authorities and the taxpayers, especially in developing countries where resources tend to be scarce and the appropriate training in such a specialized area is not readily available. Their transfer pricing regulations have, however, helped some developing countries in creating requisite skill sets and building capacity, while also protecting their tax base.

Complexity

B.1.5.9. Transfer pricing rules continue to evolve in line with the evolving way of doing business and increased globalisation, and countries around the world are implementing transfer pricing rules to deal with complex transactions and structures by MNEs. Transfer pricing compliance may involve expensive databases and the associated expertise to handle the data. Transfer pricing audits need to be performed on a case-by-case basis and are often complex and costly tasks for all parties concerned.

B.1.5.10. In developing countries resources, monetary and otherwise, may be limited for the taxpayer (especially small and medium-sized enterprises (SMEs)) that have to prepare detailed and complex transfer pricing reports and comply with the transfer pricing regulations, and these resources may have to be “bought-in”. Similarly, the tax authorities of many developing countries do not have sufficient resources to examine the facts and circumstances

⁷ *A Toolkit for Addressing Difficulties in Accessing Comparable Data for Transfer Pricing Analyses*, available from <https://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf>

of each and every case so as to determine the acceptable transfer price, especially in cases where there is a lack of comparables. Transfer pricing audits also tend to be a long, time-consuming process which may be contentious and may ultimately result in “estimates” fraught with conflicting interpretations.

B.1.5.11. In case of disputes *between* the revenue authorities of two countries, the currently available prescribed option is the Mutual Agreement Procedure as noted above. This too can possibly lead to a protracted and involved dialogue, often between unequal economic powers, and may cause strains on the resources of the companies in question and the revenue authorities of the developing countries.

Impact of the digitalization of the economy

B.1.5.12. The Internet has completely changed the way the world works by changing how information is exchanged and business is transacted. Physical limitations, which have long defined traditional taxation concepts, no longer apply and the application of international tax concepts to the Internet and related e-commerce transactions is sometimes problematic and unclear.

B.1.5.13. From the viewpoint of many countries, it is essential for them to be able to appropriately exercise taxing rights on these intangible-related transactions, such as e-commerce and web-based business models. Whether they can do so effectively using the current international taxation models is a matter of considerable debate. Many have suggested the amendment of key existing concepts, such as permanent establishment, as well as the introduction of new concepts, such as an equalization levy, to include the virtual world and its workings in the ambit of international taxation. In many developing countries, the digital economy currently plays a role as a key growth driver in their economic engine and it is therefore imperative for tax authorities to tackle transfer pricing issues related to it.

B.1.5.14. This Manual will help ensure the focus is on solutions to these problems. It will help equip developing countries to address transfer pricing issues in a way that is robust and fair to all the stakeholders, while remaining true to the goals of being internationally coherent, seeking to reduce compliance costs and reduce unrelieved double taxation.

ATTACHMENT B.2. – COMPARABILITY ANALYSIS

PROPOSED TEXT FOR CHAPTERS B.2. AND B.8. ON COMPARABILITY ANALYSIS

Note: This text was presented at the 19th Session and approved at the 20th Session. It is only included for context and hence is in shaded font. Changes from the existing text of the UN Practical Manual on Transfer Pricing for Developing Countries (2017) are shown in mark-up. Provisional numbering as at the 19th Session has been retained.

B.2.1 Rationale for comparability analysis

1. [B.2.1.1.] The term “comparability analysis” is used to designate two distinct but related analytical steps:
 - (1) An understanding of the accurately delineated transaction, which includes
 - a. The economically significant characteristics and circumstances of the controlled transaction, i.e. the transaction between associated enterprises, and
 - b. The respective roles and responsibilities of the parties to the controlled transaction. This is generally considered as part of the functional analysis, see further para. B.2.3.2.8.
 - (2) A comparison between the conditions of the controlled transaction (as established in step 1 immediately above) and those in uncontrolled transactions (i.e. transactions between independent enterprises) taking place in comparable circumstances. The latter are often referred to as “comparable uncontrolled transactions” or “comparables”.
2. [B.2.1.2.] This concept of comparability analysis is used in the selection of the most appropriate transfer pricing method, as well as in applying the selected method to arrive at an arm’s length price or financial indicator (or range of prices or financial indicators). It thus plays a central role in the overall application of the arm’s length principle.
3. [B.2.1.3.] A practical difficulty in applying the arm’s length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Where independent enterprises do not undertake transactions of the type entered into by associated enterprises, the arm’s length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises. The mere fact that a transaction may not be found between independent parties does not of itself mean that it is, or is not, arm’s length.

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4. [B.2.1.4.] It should be kept in mind that the relative lack of comparables for a taxpayer's controlled transaction does not imply that the arm's length principle is inapplicable to that transaction. Nor does it imply anything about whether that transaction is or is not, in fact, at arm's length. In a number of instances, it will be possible to use "imperfect" comparables, e.g. comparables from another country with comparable economic conditions or comparables from another industry sector. Such comparables may need to be adjusted to eliminate or reduce the differences between that transaction and the controlled transaction as discussed in paragraph B.2.1.5. below, provided such adjustments can be done reliably. In other instances, where no comparables are found for a controlled transaction between associated enterprises, it may become necessary to use approaches not depending directly on comparables to find an arm's length price³⁵ (see further Chapter B.3.). It may also be necessary to examine the economic substance of the controlled transaction to determine whether its conditions are such that it might be expected to have been agreed between independent parties in similar circumstances— in the absence of evidence of what independent parties have actually done in similar circumstances.

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

5. [B.2.1.5.] A controlled and an uncontrolled transaction are regarded as comparable if the economically relevant characteristics of the two transactions and the circumstances surrounding them are sufficiently similar to provide a reliable measure of an arm's length result. It is recognized that in reality two transactions are seldom completely alike and in this imperfect world, perfect comparables are often not available. It is therefore necessary to use a practical approach to establish the degree of comparability between controlled and uncontrolled transactions. To be comparable does not mean that the two transactions are necessarily identical, but instead means that either none of the differences between them could materially affect the arm's length price or profit or, where such material differences exist, that reasonably accurate adjustments can be made to eliminate their effect. Thus, in determining a reasonable degree of comparability, adjustments may need to be made to account for certain material differences between the controlled and uncontrolled transactions. These adjustments (which are referred to as "comparability adjustments") are to be made only if the effect of the material differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results.
6. [B.2.1.9.] Practical guidance is needed for cases without sufficient comparables. There seem to be two distinct problems relating to comparables for developing countries' tax authorities. The first is lack of access to existing sources, such as existing non-local company databases; the second is the lack of reliable local country comparables. For each of these, there are problems associated with both administration (e.g. how the lack of data impedes the reliable and efficient determination of appropriate arm's length results) and problems associated with double tax/dispute avoidance (e.g. how the lack of appropriate data impedes a developing

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country's ability to reach agreement with other tax authorities, or prevent the developing country from being taken advantage of).

7. [New, replacing B.2.1.10] In the process of undertaking a transfer pricing analysis, the first step always involves the accurate delineation of the transaction, including an awareness of the industry and market context in which the transaction takes place. From this, the most appropriate transfer pricing method can be selected (bearing in mind the likely existence of necessary data) and where appropriate, a tested party will be chosen. This process should determine what kind of comparables should be sought. Where such comparables operating in the same jurisdiction as the tested party are available there is no need to consider whether geographic differences might have a material impact on the prices or profits under review. However, in the absence of such information, foreign comparables should not automatically be rejected as all transfer pricing cases require a solution. A pragmatic approach, making use of the best available comparables will often be required. Adjustments may need to be considered and made where they improve the reliability of the comparison.

~~B.2.1.10. The OECD Transfer Pricing Guidelines point out that non-domestic comparables should not be automatically rejected. The Guidelines further recommend that where independent transactions are scarce in certain markets and industries a pragmatic solution needs to be found on a case-by-case basis.³⁵ This means that when the data are insufficient, stakeholders can still use imperfect comparables, after necessary adjustments are made, to assess the arm's length price. The validity of such procedures depends heavily on the accuracy of the comparability analysis as a whole.~~

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

B.2.2 Comparability analysis process

[as is]

B.2.3 Comparability analysis in operation

[as is]

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

[as is]

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

[as is]

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B.2.3.3 Selection of the tested party

[as is]

B.2.3.4 Identification of potentially comparable transactions or companies

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

Internal comparables

[as is]

Third-party comparable/external comparable

10. [B.2.3.4.7.] There are two types of third party or external comparable. The first type relates to transactions between two independent parties, neither of which is a party to the controlled transaction. For example, it might be possible to apply the CUP Method based on the price of a comparable product sold under comparable circumstances by uncontrolled parties.
11. [New] The second type of external comparable relates to the use of the results of comparable uncontrolled companies (engaged in comparable transactions) when applying profit-based transfer pricing methods. Typically, such results are identified through the use of commercial databases and the application of “screening” criteria. The determination of appropriate screening criteria is a critical step and should be based on the most economically relevant characteristics of the accurately delineated controlled transaction [insert cross reference to comparability factors]. The objective of finding the closest comparables must, however, also be balanced with the need to be pragmatic and to find an answer.

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

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

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

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Sources of Information for External Comparables

11. [B.2.3.4.36.] There are various sources of data and information which are available to assist a taxpayer or tax administration in identifying potential external comparables. Possible sources range from commercial or electronic databases to regulatory and other government filings and various analytical reports issued by trade and industry associations. The search objective is to identify the most reliable comparables for the controlled transaction under examination according to the specific set of criteria.
12. [B.2.3.4.37.] The data sources provide a vast array of information. Some provide simple leads or contacts, or a starting point to learn more about a particular industry so that appropriate comparables are ultimately selected. Others provide business profiles and detailed financial information about potential comparables. Each source can be important in establishing and documenting the quantitative basis for an arm's length transfer pricing policy.
13. [B.2.3.4.38.] A key resource among the general sources of information is that of commercial databases including in electronic form. These databases have been developed by various organizations which compile accounts filed by companies with the relevant administrative bodies and present them in an electronic format suitable for searches and statistical analysis. Some of these databases compile financial data from one country only, while others compile regional or even global data. These products typically provide detailed financial information as well as some textual information such as short business descriptions, although the level of detail largely depends on the country concerned.
14. [B.2.3.4.39.] The advantage of commercial databases is that they can provide the ability to sort quickly and retrieve selectively only the potential comparables that meet certain qualitative and quantitative screening criteria. Criteria commonly used for initial screening include industry codes, scale or sales volume, ownership and related/associated enterprises, availability of financial data or certain financial ratios.
15. [B.2.3.4.41.] It is important to note that commercial databases rely on publicly available information. These databases may not be available in all countries, since not all countries have the same amount of publicly available information about their companies. Further, due to the different disclosure and filing requirements depending on the legal form of the enterprise, the information may not be in a similar format, making it difficult to compare. Most of these databases are used to compare the results of companies rather than of transactions because third party transactional information is generally not readily available.
16. [B.2.3.4.42.] Commercial databases can be a practical and sometimes cost-effective way of identifying external comparables and may provide the most reliable source of information, depending on the facts and circumstances of the case. However, a number of limitations to commercial databases are frequently identified and commercial databases are not available in all countries. Further, they may be costly to use and many developing countries may not have access to them. The use of commercial databases is not compulsory, and it may be possible to identify reliable comparables from other sources of information, including internal comparables as described above, or a manual identification of third parties (such as competitors) that are regarded as potential sources of comparables for the taxpayer's controlled transaction.

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17. [New] In addition to information from commercial databases of company results, a number of other sources of information may be useful, including in some cases, price databases, publications and exchange quoted prices for commodities. Such publications may provide useful information on market conditions and prices of standard commodities. They can also be useful in understanding relevant market dynamics for the products concerned. In some cases, it may be appropriate to use quoted prices from commodities or futures exchanges in order to benchmark transfer prices for commodities. [Insert cross reference to section on 6th method] However, as with any such source of potential benchmarking data, its reliability in pricing the tested transaction must be carefully considered, particularly in the case of information in relation to less transparent markets, i.e. those in which information on individual transactions is not generally available to those who are not a party to the transaction. In such cases, the published information will typically be based on the publisher’s observations and contacts with key market participants. While this kind of information can be useful, it should be borne in mind that the publisher may have made adjustments to the raw data in ways that may not be apparent. Such data should therefore be used with care.
18. [B.2.3.4.43] Other sources of comparable data may include the following:
- Government sources—many governments and regulatory agencies maintain databases on several industries. Such sources can be located on the agency’s Internet websites;
 - Trade institutions and organizations—often these institutions or organizations will maintain databases and research reports, and/or hold files with data on potential comparables. Generally, these institutions or organizations would be:
 - Chambers of commerce;
 - Trade and professional organizations;
 - Embassies, consulates or trade missions; or
 - International organizations (e.g. the United Nations, the Organisation for Economic Co-operation and Development, the World Bank, the International Monetary Fund).
 - ~~Taxpayer or~~ Other sources of knowledge on competitors or other entities which may make suitable comparables

Approach to identifying potential comparables [MOVED to follow 2.3.4.8]

19. [B.2.3.4.25.] In identifying potentially comparable uncontrolled transactions or enterprises two approaches are possible: the “additive” and the “deductive”.
20. [B.2.3.4.26.] In the additive approach a list is prepared of potentially comparable uncontrolled transactions or of third parties which are believed to be carrying out potentially comparable transactions. As much information as possible on these transactions is then collected to confirm whether they are in effect acceptable comparables, based on the economically relevant characteristics for the controlled transaction. When adopting the additive approach special care should be taken in order to provide a reliable comparable; it is not sufficient that a third-party company be well-known in the relevant industrial sector. Also, one needs to avoid potential third party companies who themselves have transfer pricing issues.

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21. [B.2.3.4.27.] The deductive approach usually commences with a search on a database for comparable companies or transactions. These can be commercial databases developed by editors who compile accounts filed by companies with the relevant governmental authorities, or proprietary databases developed by advisory firms. The approach typically starts with a wide set of companies that operate in the same sector of activity, perform similar broad functions, and do not present economic characteristics that are obviously different.
22. [B.2.3.4.28.] It should be emphasized that the exclusive use of either of the two approaches may not yield valuable results. Depending on the facts of each case, one of the above two approaches can be used or both in combination.
23. [B.2.3.4.29.] It is possible that companies identified using the additive approach may not have been identified when using the deductive approach. This may in some cases suggest that the search strategy applied under the deductive approach is not sufficiently robust and should be reassessed, or simply that certain information is not contained in the database selected. Therefore, the additive approach could be useful for assessing whether the deductive search strategy is reliable, comprehensive and appropriate given the economic characteristics being considered.
24. [B.2.3.4.30.] It is very important that the taxpayer or tax administration using the “additive” and/or “deductive” approaches justifies and documents the criteria used to include or exclude particular third-party data from the pool of potential comparables, in order to ensure a reasonable degree of objectivity and transparency in the process. In particular, the process should be reproducible by the taxpayer and by the tax administration that wishes to assess it. It is also very important that third party data be refined using qualitative criteria. It would be improper to use financial information relating to the transactions of a large sample of companies that have been selected solely because they are classified in a database under a given industry code.

Deductive approach: initial identification and screening of comparables

25. [B.2.3.4.31.] The next step, after having developed a set of comparability criteria that are tailored to the specifics of the controlled transaction at issue, is to conduct an initial identification and screening of potential independent comparables. The objective in this initial screening, where performed using a commercial database, is to identify substantially all companies that have a reasonable probability of demonstrating the threshold comparability requirements and of providing verifiable, objective documentary evidence of market pricing or profits. In other words, the desired initial result is to obtain the largest possible pool of potential independent comparables for subsequent screening, verification, and analysis. Where comparables are selected from information sources other than databases this part of the process may be different.
26. [B.2.3.4.32.] The process of screening, verification and selection of comparables will largely depend upon the availability of databases in the public domain in the country. Public databases may be available in some countries whereas other countries may not have these databases. In such cases, one of the options could be to rely on a database from a comparable economy with reasonable and reliable adjustments.
27. [B.2.3.4.33.] The following analytical needs and constraints should, however, be kept in mind:

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- The search process should avoid any systematic biases;
- The screening process must be executed and documented in a manner consistent with the general requirement for due diligence; and
- It should be recognized that some of the initial comparables will be eliminated in subsequent stages of screening and analysis

~~Secondary screening, verification and selection~~

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

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

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

[Paragraph B.2.3.4.43 moved above]

Examination of the economically relevant characteristics of the transaction

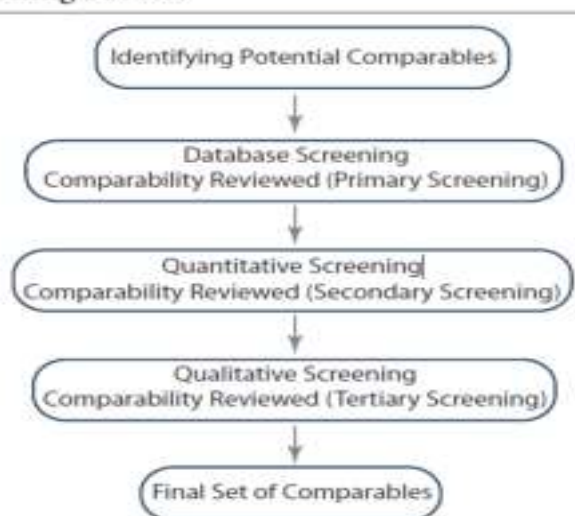
30. [New] Examination of the economically relevant characteristics of the accurately delineated controlled transaction will help in the selection of the most appropriate transfer pricing method and in developing search criteria to identify reliable comparables with which to apply the selected method.

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Development of comparable search or “screening” criteria

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

**Figure B.2.1:
A Typical Screening Process**



Database Screening (Primary Screening)

33. [New] The determination of appropriate screening criteria will depend on the most economically relevant characteristics of the accurately delineated transaction. Typically, they will begin with the industry code and include screens to ensure the transactions engaged in by the potential comparables are indeed comparable and uncontrolled, and that sufficient financial information is available and can be relied upon. While screens based on industry codes and geographic market are commonly applied, it is always important to consider what characteristics are most economically relevant to the accurately delineated tested

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transaction(s). For instance, functional comparability may be more important than similarity of industry or market. In such cases, indiscriminate application of the less relevant criteria may be unhelpful, resulting in no comparables being left with which to apply the transfer pricing method.

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

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

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

1 Industry/business activity qualification codes

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

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

2 Geography/region/country/market

It generally makes sense to consider potential comparables from the same geographic market as

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

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

3 Key words related to the business activity

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

4 Availability of financial information

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

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

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

6 Independence, public vs privately held companies

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

There can be advantages to restricting the search to publicly held companies since disclosure and audit requirements for such companies are typically more rigorous. Public companies are also generally required to provide considerably more detail in their audited financial statements and in the accompanying notes and management review of operations. However, in many cases, whether

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or not a potential comparable is publicly held is likely to be less important as a comparability factor than other considerations such as functional similarity. Thus, where data are scarce, eliminating potential comparables on this basis may not be pragmatic.

7 Type of financial accounts

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

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

8 Active/inactive entities

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

9 Primary screening for functional comparability

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

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

Quantitative or Secondary screening, verification and selection

36. [B.2.3.4.34.] The quantitative screening step involves further screening the financial information relating to the potential comparables for the relevant period to determine whether their activities are comparable to that of the tested party, and they report sufficient data at the level needed to apply the selected transfer pricing method. Under this step, the search process focuses on a rigorous review of each transaction or company in the potential independent comparable pool against the full range of specific screening criteria. The objectives at this stage are verification, final screening and selection. This process is based on trial and error and requires multiple data sources, cross-checks and selected follow-up and confirmation of

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factual data. It will often be difficult to find ‘perfect’ comparables for a controlled transaction. Therefore, in undertaking the screening process, judgement is required. If the primary screening is applied too rigorously and inflexibly, it may be the case that no apparent comparables remain. In such cases it is particularly important to focus on the most economically significant characteristics of the controlled transaction while dispensing with other, less critical screening criteria for the transaction at hand (e.g. industry code or geographic location). Where this is the case, secondary screening can be particularly useful to refine the set of potential comparables.

37. [B.2.3.4.21.] For example, such screening may be done using diagnostic ratios. Diagnostic ratios are financial ratios applied to reject comparables that do not fulfil certain criteria.
38. [New] Particularly in cases where broad primary screening criteria have been used, diagnostic ratios can be used to improve the reliability of a potential set of comparables by helping to distinguish between results from transactions with differing degrees of comparability, and seeking to eliminate those with a lower degree of comparability from the potential comparable set. One or a combination of diagnostic ratios may be used as a kind of additional screen to narrow a range in cases where comparability defects remain in the potential comparables set that are otherwise difficult to eliminate, resulting in range that would otherwise be overly wide.
39. [New] For example, a ratio of marketing and advertising expenses to sales could be an indicator of the intensity of the marketing and advertising function undertaken. This ratio could then be used to refine the arm's length range based on comparables with similar levels of marketing / advertising intensity in cases where the tested party makes sales to independent customers. Note that it would generally not be reliable to use a diagnostic ratio which comprises elements that are themselves the subject of related party transactions.
40. [B.2.3.4.22.] The application of diagnostic ratios is based on the assumption that a diagnostic ratio reflects a value driver of a particular line of business and is a reflection of the comparable functional and risk profile. In practice, it also depends on data availability. Most countries with transfer pricing rules acknowledge that the application of a net margin method is less sensitive to product and functional similarity than a traditional transaction method. However, functional comparability is still required in practice so a proper functional analysis and a good understanding of the tested business are essential in determining what diagnostic ratios may be useful, and to help avoid “cherry picking” or subjective use. Diagnostic ratios enable some of the features of a potential comparable that are economically relevant for the comparable search process to be taken into account when performing the comparable search.
41. [B.2.3.4.23.] In order to identify potential comparables with a similar functional and risk profile a diagnostic ratio measuring for example the level of wage costs compared to an appropriate base (e.g. total operating costs or total turnover) can be used as a yardstick to measure the level of technical manpower employed by comparable companies engaged in software development. The identification of a diagnostic ratio will depend upon several factors such as geographical location; the nature of the business, product and services; the product and service market etc. Using diagnostic ratios may help to identify comparables which are in line with the functional and risk profile of the tested party.
42. [B.2.3.4.24.] The diagnostic ratio is applied by using cut-off criteria. With this method, financials of the tested party are used to calculate the diagnostic ratios and these ratios are then

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used to create minimum or maximum values to reject companies. Once a cut-off is determined, generally all the values above or below a particular range of the cut-off will be eliminated, depending upon the facts and circumstances of each case. Subsequently, based on the functional and risk profile of the tested party, all companies with a diagnostic ratio above and below the cut-off range will be excluded.

Box – examples of diagnostic ratios

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

Some examples diagnostic ratios are set out below:

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

Qualitative or Tertiary screening and interpretation of the data

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

B.2.3.5 Adjustments to comparables

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

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

44. [New] A comparability analysis may result in an “arm's length range” of financial indicators (prices or margins), all of which are considered to be equally reliable. (Note that in some countries, the domestic law will specify how such a range is to be derived from the final results of the comparables, for instance by the use of particular statistical techniques.) Where the transfer price is within this range, it is normally accepted as arm's length.
45. [New] However, it may be difficult to determine whether the search process has indeed resulted in a range of results, all of which are equally reliable. Uncertainty may also arise in cases where the range of results from a comparables search is very wide. Where such concerns exist therefore, it can be helpful to consider whether it is possible objectively to determine whether some potential comparables are more reliable than others. The (further) use of diagnostic ratios and qualitative screening can sometimes be helpful in this regard.
46. [New] The search for reliable comparables is at the heart of most transfer pricing analyses. In many cases, it may not be straightforward, but rather, require the application of judgement. Care should thus be taken to consider potential screening criteria as objectively as possible, and avoid ‘cherry-picking’ data. Similarly, absent factual changes, it would be expected that such criteria would be used consistently over time.

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

[as is]

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B.8.5. PRACTICAL GUIDANCE FOR CASES WITHOUT SUFFICIENT COMPARABLES

47. [B.8.5.1.] A critical issue for developing countries as well as developed countries when applying any methodology will often be the lack of third-party comparables, particularly comparables from the domestic market. As this Manual has shown, however, in many cases it may be the case that foreign comparables will be appropriate for the transfer pricing case at hand. Where this is not the case, for instance where it is found that the most appropriate method involves a local tested party and there are particularities in relation to the domestic market that mean foreign comparables are unlikely to be reliable, practical guidance in applying the arm's length principle and the transfer pricing rules without sufficient domestic information on independent comparables should be a key focus in domestic legislative frameworks. This Manual as a whole is intended to assist especially in this area; users should refer to Chapter B.2. on Comparability Analysis in particular. Domestic legislative frameworks and administrative guidelines should generally address the analysis of comparables as a benchmark of the arm's length principle. Such frameworks should seek to establish useful and effective guidance on matters such as comparability analysis (use of foreign data, adjustment of differences, profit split etc.), access to data, safe harbour rules, if any, and burden of proof. It is worth paying attention to the new [replace with cross reference to Sixth method in the Manual]⁷⁵ See the chapter on Methods (Chapter B.3. of this Manual) for more details.
48. [New] In addition, the Toolkit Addressing a Lack of Access to Comparables for Transfer Pricing Analyses contains a number of useful suggestions that could be considered in cases where there is a systemic problem involving a lack of comparables. For example, the toolkit:
- Suggests ways in which government agencies can increase the pool of available comparables data, for example, by instituting requirements to publish audited financial statements
 - Recommends focusing on risk assessment approaches that consider the arm's length nature of related party transactions, so as to ensure scarce audit resources are concentrated on cases most likely to yield results
 - Suggests consideration of safe harbours, fixed margins or other prescriptive approaches *[insert cross reference to sections below on presumptive approaches B.8.7 and safe harbours B.8.8]*
 - Discusses the application of the profit split method and the use of valuation techniques which do not directly rely on comparables data, where it is found that such approaches constitute the most appropriate means of determining arm's length prices or profits
 - Suggests consideration of cooperative compliance approaches in appropriate cases as a means of helping tax administrations to access industry information which may otherwise be difficult to obtain. Suggests the use of anti-avoidance measures as a backstop to the transfer pricing rules in the most egregious cases, or those where there is a high risk of systemic abuse.

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49. [B.8.5.2.] Ease of administration is another important issue in the design of legal frameworks. Documentation requirements supported by penalties for non-compliance are the main instruments used by tax authorities for collection of sufficient information to test whether or not taxpayers have established an arm's length result. Preparing documentation is one of the most expensive compliance costs for MNEs, especially if there are differences in countries' requirements. There is value in seeking to align documentation requirements with those of other countries, especially in the same region, unless there are good reasons in terms of reducing compliance and collection costs, or specific features of local legislation, that require differences. The OECD/G20 BEPS Project specifically focused on transfer pricing documentation and country-by-country reporting. In October 2015 a report providing guidance on the implementation of these measures under action 13 was published.⁷⁶
50. [B.8.5.3] Some differences in the coverage of transactions or in the legal form (statutes with penalty provisions or administrative guidance on self-assessment) will remain. It is therefore appropriate to continuously evaluate documentation and penalty legislation for efficiency and proportionality. The experience of countries that have introduced transfer pricing rules may be relevant to developing countries just starting to develop capability in transfer pricing. For example, at the initial stage of transfer pricing administration in the early 1990s, Japanese transfer pricing examiners experienced difficulties in collecting information about affiliated enterprises that was physically held overseas. Documentation requirements were very basic under Japanese domestic legislation at that time; examiners had to exercise their ordinary domestic investigation powers to inquire from taxpayers about international related party transactions. They soon identified that not all relevant information was necessarily kept by the Japanese unit. Japan therefore started a process of adjusting documentation requirements to reflect the actual international business practice of multinational groups by ensuring effective compliance but also taking into consideration the taxpayers' compliance burden. See Chapter C.2. on Documentation for specific country practices.

This text was first considered at the 20th Session and is for approval at the 21st Session

PART B.2.4.7. -

REVISED TEXT ON USE OF CUSTOMS VALUATION

[Mark-up shows changes from 2017 edition of the Manual]

B.2.4.7. Use of Customs Valuations

B.2.4.7.1. The price paid or payable for the goods (~~which~~ and under certain limited circumstances the costs of services and royalties are added ~~are added~~) ~~to the customs value~~ ~~the so-called “adjustments”~~) in import trans-~~actions~~ is the starting point for determination ~~of any applicable~~ ~~of the assessment of~~ customs duties. A higher price on import reduces the profit of the importer (all other things being equal) and thus the direct tax that might be due in the importing country. However, where customs duties apply, this would also result in higher duties being payable, ~~while a low price on import lowers the customs duty~~. Accordingly, there may be ~~perhaps~~ an inherent conflict between the revenue implications and the motivation of the customs and direct tax authorities. While the direct tax authority would focus on overvalued import prices, ~~may seek to lower the price on import to stop diversion of profit,~~ the customs authority will seek to ensure that the declared customs value has not been *undervalued* to reduce duty liability.

B.2.4.7.2. The WTO Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 (“the WTO Valuation Agreement”) sets out the methodology for determining the customs value of imported goods. Customs valuation is the procedure applied to determine the customs value of imported goods for the purpose of calculating ad valorem customs duties. Article 22 of the WTO Valuation Agreement requires that each Member of the WTO shall ensure the conformity of its laws, regulations and administrative procedures with the provisions of the Agreement. Members of the WTO are required to give effect to the Agreement in national legislation.[†] In contrast, for direct tax purposes, ~~t~~The tax authorities in most ~~of the member~~ countries use the “arm’s length principle” as a standard for valuing cross-border

[†] See http://www.wto.org/english/tratop_e/cusval_e/cusval_e.htm.

ATTACHMENT B.3. – CUSTOMS VALUATION

~~related party transactions as set out in OECD Transfer Pricing Guidelines.~~ It is important to note here that while both customs valuation and transfer pricing approaches the methodologies set by the WTO and OECD aim at determining an appropriate price for cross-border related party transactions, as if the parties were not related; the approaches of the Customs authorities and direct income tax authorities are, however, often different and in some cases may be ~~and~~ incompatible due to different motivations, theoretical frameworks, documentation requirements ~~and or~~ other factors, causing practical difficulties for importers. Therefore, ~~There is a need to achieve a convergence of transfer pricing and customs valuation through~~ better coordination and exchange of information between ~~these two~~ direct tax and customs authorities is encouraged. However, the extent to which this is possible it may depend on how the customs services and tax administrations are organized in each country. For some countries the two organizations are more integrated, and for others they are completely separate.

B.2.4.7.3. In appropriate circumstances the verified customs value may be useful to tax administrations in evaluating the arm's length character of the transfer prices of imported goods in international transactions between associated enterprises. In particular, customs may have contemporaneous information regarding the transaction that could be relevant for transfer pricing purposes, while tax authorities may have transfer pricing documentation which provides detailed information on the circumstances of the transaction.

B.2.4.7.4. Some customs administrations are now also making use of transfer pricing data, ~~as where relevant~~ appropriate, to ensure that the price of an associated party transaction has not been affected by the special relationship between the parties. ~~Customs authorities may use comparisons between the value attributable to goods imported by associated enterprises and the value for identical or similar goods imported by independent enterprises, where available,~~ or alternatively may examine the circumstances surrounding the sale.

B.2.4.7.5. There are ~~some~~ similarities between customs valuation and transfer pricing methods, for instance, one method permitted for the purposes of verifying customs values uses a comparison between the value of the goods imported by a related party with the value of identical or similar goods imported by independent parties, which may be considered as analogous to the application of a CUP method for transfer pricing. ~~although the former may not be aligned with the latter.~~ Examining customs values may thus provide relevant information and a useful starting point for transfer pricing purposes in some cases and may also help in reducing the compliance burden for taxpayers.

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However, it should be borne in mind that customs valuation methods are highly prescriptive and may not be fully aligned with the arm's length principle as it applies for direct tax purposes.

~~B.2.4.7.4. — Even when utilizing import customs values in a transfer pricing context, certain additional upward or downward adjustments may be required to derive the arm's length price for the purpose of direct income taxation. Such adjustments may have an impact on the customs value.~~

B.2.4.7.5~~6~~. There has been~~is~~ a great deal of focus internationally on the interplay between transfer pricing and customs valuation methods. Following two joint World Customs Organization (WCO)–OECD conferences in 2006 and 2007, it became clear that harmonization of the two systems was not a realistic proposition; particularly given the fact that the WTO Valuation Agreement is not expected to be updated in the short to medium term. Discussions have therefore focused on the extent to which customs may use transfer pricing information when carrying out examination of related party transactions. The principle of the customs valuation in cases involving related party exporters and importers and where there are doubts as to the reliability of the price paid or payable for the goods, is to judge whether the special relationship between the parties of the seller and the buyer influenced the price by examining “the circumstances surrounding the sale” (WTO Valuation Agreement Article 1, paragraph 2(a)).

~~B.2.4.7.7. NEW The transfer pricing report has been used to ascertain the circumstances surrounding the sale.~~ The WCO's Technical Committee on Customs Valuation, which has the mandate for ensuring, at the technical level, uniformity in interpretation and application of the WTO Valuation Agreement, has issued a few several~~two~~ instruments on this topic.² These are briefly summarised below.

~~B.2.4.7.8. NEW~~ Commentary 23.1, ~~which~~ recognizes the principle that a transfer pricing study may, in some cases, be used by customs as a basis for examining the circumstances of the sale, ~~on a case-by-case basis;~~ and ~~Following this general principle,~~ Case Study 14.1, ~~which~~ sets out a scenario where customs use transfer pricing documentation data, based on the transactional net margin method, to confirm that the prices applicable in a related party transaction have~~s~~ not been influenced by the relationship between those parties.

² WCO Guide to Customs Valuation and Transfer Pricing (New edition 2018) ANNEX III, VI and VII, which Guide is available at <http://www.wcoomd.org/-/media/wco/public/global/pdf/topics/key-issues/revenue-package/wco-guide-to-customs-valuation-and-transfer-pricing.pdf?la=en>.

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B.2.4.7.9. NEW, and Case Study 14.2, also provides an example of customs authorities making use of –which examined the transfer pricing information (based on the resale price method) but in contrast concludes that report showing that gross margins earned by comparable companies was between 35%–46% with a median of 43%.— On the other hand, the importer (distributor) earned the gross margin of 64%.— The Technical Committee decided that the declared import price was not settled in a manner consistent with normal pricing practices of the industry but rather had been influenced by the relationship between the buyer and seller.³

B.2.4.7.610. The WCO has produced the WCO a–Guide to Customs Valuation and Transfer Pricing (New edition 2018)⁴ aforementioned, which includes all relevant technical information on the two methodologies and explores the interaction between them. It includes good practices for customs and tax administrations, and businesses. In particular, customs and tax administrations are encouraged to work more closely together and the guide emphasizes that businesses should consider customs’ needs when developing transfer pricing strategies. To this end, the WCO has produced Guidelines for Strengthening Cooperation and the Exchanging of Information between Customs and Tax Aauthorities at the National Level (October 2016).⁵⁶ These Guidelines endeavour to provide guidance and ideas to customs and tax authorities for formalizing the contacts and strengthening the existing cooperation at the national level, on a range of issues of mutual interest.

³

Available in the WCO Valuation Compendium, via the WCO Bookshop:–
<http://wcoomdpublications.org/valuation/compendium-customs-valuation.html>.

⁴ Available from –

⁵ Available at http://www.wcoomd.org/~media/wco/public/global/pdf/topics/facilitation/instruments-and-tools/tools/customs-tax-cooperation/customs_tax_guidelines_en_final2.pdf?db=web

⁶ Available from

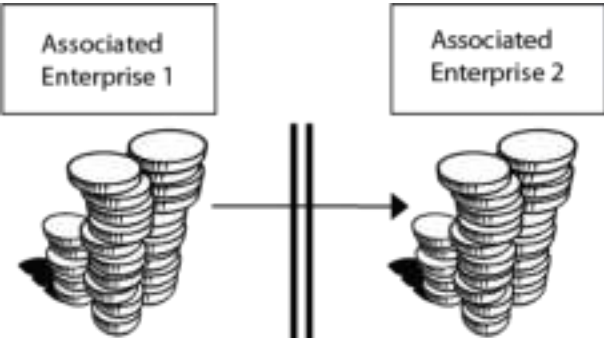
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APPROVED TEXT FOR CHAPTER B.3.3 ETC - PROFIT SPLITS

This chapter was approved at the 19th Session and is **included only for context**, hence it is in **shaded font**. Changes from the previous edition of the Manual are also in shaded background

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

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

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<p>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>	<p>See paragraph 8 et seq.</p> <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, 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 distinguished from global formulary apportionment approaches as follows. The profit split method typically does not start with the global or total combined profits of the entire MNE group. Rather, it begins from the relevant profits in relation to particular transactions between two or more associated enterprises. Moreover, in order to comply with the arm's length principle, the way in which the method is applied should not be arbitrary, but rather should approximate the results achieved had the parties been independent of each other. In particular, the factors by which the relevant profits are split between the associated enterprises to the transaction is typically based on measures of their relative contributions to value creation rather than an arbitrary formula.</p>
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[MOVED BELOW]

[B.3.3.16.] Strengths and Weaknesses

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

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11. The presence of any one or more of these indicators suggests that the profit split may be the most appropriate method.

12. Where one or more of the above indicators is present, it is highly unlikely that reliable comparable transactions will be available. However, a lack of comparables per se is insufficient evidence to conclude that a profit split will be the most appropriate method. That is, the profit split method should not become a convenient method to be applied in every case where close comparables cannot be identified.

13. In contrast, where none of the indicators are present and the accurate delineation of the transaction shows that one of the related parties to the transaction performs functions, uses or contributes assets and assumes risks that can be reliably benchmarked by reference to uncontrolled comparables, a profit split is unlikely to be the most appropriate method. In such cases, it is likely to be more reliable to apply a transfer pricing method making use of the uncontrolled comparables, even in cases where ‘perfect’ or closely comparable uncontrolled transactions are lacking. See *[insert cross reference to lack of comparables.]* As with any other method, pricing practices used between independent parties engaged in similar transactions in the same industry or market can provide information relevant to the analysis of the most appropriate transfer pricing method.

14. It is sometimes argued that since the profit split method is seldom used among independent enterprises, its application in controlled transactions should be similarly rare. Whether or not the premise of this argument is correct, where the method is found to be the most appropriate to the circumstances, this should not be a factor. Transfer pricing methods, including the profit split method, are not necessarily intended to replicate the way in which independent parties establish prices among themselves; rather, they are a way in which the arm’s length principle can be applied in order to determine appropriate transfer prices in controlled transactions. That said, if there is evidence (e.g. from a joint venture or similar arrangement) that independent parties in comparable circumstances use a profit split method among themselves, this may suggest that a profit split will also be the most appropriate method in relation to the controlled transactions.

Unique and valuable contributions by each party

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

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

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

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

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

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

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

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

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

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

Example 2 [Unique and valuable DAEMPE functions]

Dades Enterprises, a resident of country G is in the business of software development and provides tailored software solutions to customers. Dades Enterprises has developed certain proprietary software relating to 3D mapping of underground aquifers. Subsequently, Dades Limited, a resident of country I and a member of the same MNE group as Dades Enterprises, enters into an agreement with Client M, an independent party, for the supply of similar software, tailored to the mapping of underground liquid hydrocarbons. Dades Enterprises provides Dades Limited with access to the relevant code, software designs and know-how developed in the

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original project. The legal agreement between the entities states that Dades Enterprises will retain legal ownership in any and all resulting software based on the original product.

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

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

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

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

Highly integrated operations

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

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

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

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

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

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

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

While Schol Manufacturing and Schol Distribution are highly dependent upon each other, an appropriate arm's length remuneration for each of them can be determined without the need to consider their activities together. For example, the distribution activities of Schol Distribution might be able to be reliably benchmarked through the application transactional net margin method and looking to comparable uncontrolled distributors. In this case therefore, the profit split is unlikely to be the most appropriate method.

Shared risks

20. A further indicator that the profit split may be the most appropriate method is where the parties to controlled transaction share the assumption of the economically significant risks in relation to the transaction [\[insert cross reference to section on risk\]](#). It may also be the most appropriate method in cases where the parties separately assume risks that are so closely related or inter-linked that the playing out of the risks of each party cannot be reliably isolated from the risks assumed by the counterparties.

21. The relevance of risk-sharing to the determination of the most appropriate transfer pricing method will depend greatly on the extent to which the risks concerned are economically significant such that each party should be entitled to a share of the relevant profits associated with the controlled transaction(s) had the transaction occurred at arm's length.

Example 5 [Shared assumption of risks]

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

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

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

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

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

Availability of information

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

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

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

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associated enterprises, including the contribution and residual analysis approaches. These are discussed in more detail below.

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

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>26. There are several ways in which the profit split method can be applied.</p>
	<p><i>Contribution Analysis</i></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>27. Under a contribution analysis, the relevant profits are allocated between the associated enterprises engaged in the controlled transactions in a way that aims to reflect a reasonable approximation of the divisions that would have been agreed by independent enterprises in similar circumstances. Relevant external market data, i.e. from comparable independent transactions between unrelated enterprises or between the taxpayer and an unrelated enterprise, should be used to support this allocation where available. However more commonly, such external data will not be obtainable. In such cases, the arm’s length principle can be applied by using data internal to the taxpayers themselves to determine the relative value of the contributions of each party to the controlled transaction(s). For example, this might be done by comparing the</p>

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	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).
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.	28. The way in which the value of such contributions is measured will depend on the facts of each case. The determination of appropriate profit splitting factors is discussed in more detail below [See paragraph 46 et seq]. Note that if the relative value of the contributions can be determined, then calculating the actual value of the contribution of each enterprise may not be required.
	<i>Residual analysis</i>
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:	29. While a contribution analysis takes the relevant profits in relation to the transaction and splits them between the parties in a single step, the profit split method can be applied using a staged approach under a residual analysis. Such an approach is likely to be appropriate where one or more parties to the controlled transaction(s) makes a contribution(s) which is routine and could be benchmarked based on comparables.
➤ <i>Step 1:</i> allocation of sufficient profit to each enterprise to provide basic arm’s length compensation for routine contributions. This basic compensation does not include a return for possible valuable intangible assets owned by the associated enterprises. The basic compensation is determined based on the returns earned by comparable independent enterprises for comparable transactions or, more frequently, functions. In practice TNMM is used to determine the appropriate return in Step 1 of the residual analysis; and	30. <i>Step 1:</i> allocation of an arm’s length profit to each enterprise to compensate it for its routine or benchmarkable contributions. Typically this is done by the application of one-sided transfer pricing methods such as the TNMM and consideration of the returns earned by independent enterprises engaged in activities which are comparable to those routine or benchmarkable contributions. In this first step, other contributions, such as those which are unique and valuable, are not taken into account. Each related party is allocated an appropriate ‘routine’ return from the pool of relevant profits.
➤ <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	31. <i>Step 2:</i> allocation of residual profit (i.e. remaining relevant profits after the Step 1 allocation) on an economically valid basis. In the second step, other contributions not already

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<p>property then the allocation of this profit should be based on the relative value of each enterprise’s contributions of intangible property.</p>	<p>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>32. As has been noted above, since reliable, direct information on how profits would have been allocated in comparable uncontrolled transactions might not be available, care is required in applying the profit split method. The residual approach to the application of the method aims to reduce possible subjectivity by confining, to the extent possible, the more difficult step 2 allocation (which is typically not based directly on comparables data).</p> <p><i>Example 6</i></p> <p>[added from B.3.3.14.5] Company X manufactures components using unique and valuable intangibles and sells these components to a related party, Company Y. Company Y then uses the components, together with its own unique and valuable intangibles, to manufacture final products, which it sells to independent customers. The first step of the residual analysis would allocate a basic, ‘routine’ or benchmarkable arm’s length return to Company X for its manufacturing function, and a basic, ‘routine’ or benchmarkable arm’s length return to Company Y for its manufacturing and distribution functions. The relevant profits from the transactions, less the amounts of the basic or ‘routine’ returns to Company X and Company Y, will be the residual profit. This residual profit is then split between the parties based on the relative value of their respective unique and valuable contributions. This second step of splitting the residual profits need not, and typically does not, depend on the use of comparables.</p>

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<p>B.3.3.14.6. The following approaches have been specified in some jurisdictions to determine the relative value of each company’s contributions of intangible property:</p> <ul style="list-style-type: none"> ➤ External market benchmarks reflecting the fair market value of the intangible property; ➤ The capitalized cost of developing the intangibles and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible; and ➤ The amount of actual intangible development expenditures in recent years if these expenditures have been constant over time and the useful life of the intangible property of all parties involved is broadly similar. 	<p>33. The following approaches have been specified in some jurisdictions to determine the relative value of each company’s contributions of intangibles:</p> <ul style="list-style-type: none"> • External market benchmarks reflecting the fair market value of the intangible property; • The capitalized cost of developing the intangibles and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible;¹ and • The amount of actual intangible development expenditures in recent years if these expenditures have been constant over time and the useful life of the intangible property of all parties involved is broadly similar.
<p>B.3.3.14.7. The Residual Profit Split Method is used more in practice than the contribution 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>34. The residual 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 or methods. The second step analyses returns to unique and valuable contributions or other elements which are un-benchmarkable. Rather than trying to determine absolute values for these contributions based on comparables, the method focuses on their relative value which may often be determined more reliably. Secondly, potential conflict with the tax authorities is reduced by using the two-step residual approach since it reduces the amount of profit that is to be split in the potentially more controversial second step.</p>
<p>B.3.3.18. Examples: Application of</p>	<p><i>Example 7 – Application of residual profit split²</i></p>

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

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

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Residual Profit Split	
<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 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</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 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</p>

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<p>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 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>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 XYZ contributed a third (or \$0.20 per dollar of sales) and XYA-Asia contributed two thirds (or \$0.40 per dollar of sales). Accordingly, it is determined that an arm’s length split of the residual profits would see one third of those profits being allocated to XYZ and two thirds being allocated to XYZ-Asia.</p>
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<p>B.3.3.15. Comparable Profit Split Method</p>	<p><i>Comparable profit split method</i></p>
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	<p>35. In some countries, reference is made to the comparable profit split method. This application of the profit split method relies on a comparison of the allocation of profits between independent enterprises engaged in comparable activities under comparable circumstances to those of the controlled transaction(s). That is, it relies heavily on external market data to determine how the relevant profits should be split between the related parties. As has been noted above, such information may be very useful, but is rarely available in practice.</p>
<p>B.3.3.15.2. The contribution analysis and the Comparable Profit Split Method are difficult to apply in practice and therefore not often used. This is especially the case because the reliable external market data necessary to split the combined profits between the associated enterprises are often not available.</p>	<p>[Delete]</p>

Determining the profits to be split

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

Measures of profit

- 39. The profit split method is most commonly used to split net or operating profits. Applying the method in this way means that all the related parties are exposed to both the income and expenses associated with the relevant transactions in a consistent manner. However, depending on the accurate delineation of the transaction, other measures of profits may be appropriate. For example, if gross profits are split, each related party would then deduct its

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own operating expenses. Such an application may be appropriate where the parties do not share the risks associated with the operating expenses relating to the controlled transaction, but do share the risks associated with the volume of sales and prices charged, as well as those associated with the production or acquisition of the goods or services.

Example 8 [Measures of profit]

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

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

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

Accelory assumes all of the risks in relation to the overall production and sale of the new generation of products. In this example, although Accelory and TurboAcc each assume separate economically significant risks, those risks are highly interdependent. As a result, the profit split is found to be the most appropriate method. In this case, while the overall fortunes of the companies are highly interdependent, each company operates very independently and has no involvement in or control over the operations of the other. Therefore, a profit split of revenues from Accelory's sales of the product or the relevant gross profits of both Accelory and TurboAcc from the transactions may be the most appropriate way to apply the profit split method. In this way, each party will bear the financial consequences of the playing out of risks relating to their own operating expenses (and cost of sales in the case of a split of revenues).

Actual or anticipated profits

40. The profit split method is most commonly applied to split the actual relevant profits of the related parties in relation to controlled transactions. Since actual profits will reflect the playing out of the risks which affect the transactions, such a split will typically result in each related party being subject to those risks. It would thus be appropriate where the accurate delineation of the transaction shows that each related party shares such risks. For example, where the parties to the controlled transaction share the assumption of the economically significant risks, or separately assume closely-related economically significant risks in relation to the controlled transactions, it would be expected that a split of actual profits would apply.

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41. On the other hand, where the profit split is found to be the most appropriate method but the accurate delineation of the transaction shows that one or more of the related parties does not share in the assumption of the economically significant risks, a split of anticipated profits is likely to be more appropriate.
42. A common application of an anticipated profit split is in the use of a discounted cash flow valuation technique, which might be used, for example, to determine the present value of a transferred intangible or other asset. For example, Company A transfers all the rights in a fully developed unique and valuable intangible, intangible X, to Company B, its associated enterprise. Company B has its own unique and valuable intangibles which are expected to complement intangible X. Company A expects to have no ongoing involvement in the exploitation of intangible X, as these activities will be wholly undertaken and controlled by Company B. In this case, assume it is determined that the profit split is the most appropriate method since both Company A and Company B make unique and valuable contributions. However, since Company A will not be involved in the ongoing exploitation of the intangible after the transfer, and it does not assume any risks relating to those exploitation activities, at arm's length, its return should not be subject to those risks. Instead, it should receive a share of the anticipated profits from the Company B's exploitation of the combined intangibles of Companies A and B, discounted to reflect its present value at the time of the transfer. This amount might be calculated using a discounted cash flow valuation technique which analyses the present value of the likely income from the exploitation of intangible X. The ongoing risks relating to the exploitation of the intangibles are solely assumed by Company B and no adjustment to the remuneration due to Company A needs to be made should the intangible actually be more or less successful than anticipated.
43. It should be noted that measures of profits which vary to some degree with the playing out of risks, without being fully exposed to such risk, can also be used. In all cases, the measure of relevant profits to be split should be aligned with the accurate delineation of the transaction in order to produce an arm's length outcome.
44. Even where a profit split of actual profits is used, the method should be applied without hindsight. That is, unless there are significant unforeseen developments which would have resulted in a renegotiation of the agreement had it occurred between independent parties, the basis for determining how the relevant profits should be calculated and how they should be split amongst the associated enterprises should ordinarily be determined based on information known or reasonably foreseeable at the time of, or prior to the transaction(s). This is the case even though it may only be possible to apply the actual calculations some time thereafter. For example, Company E and its associated enterprise, Company F are so highly integrated that the profit split method is found to be the most appropriate method to evaluate the controlled transactions between them. The way in which the relevant profits from their transactions should be determined is established ex ante, that is, at or prior to the time they engage in the transactions. At that time, they also determine that the residual profit split method of actual net profits should be applied, and that the residual profits should be split between them on the basis of the value of current year marketing expenses of each party, after having allocated basic or 'routine' returns on the routine sales and distribution activities conducted by both Companies E and F. In this example, the way in which the profit split method is to be applied is determined at the start of the period. However, the agreed method can only be applied at year end, once the amount of sales, marketing expenses, and the

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amount of the relevant actual net profits has been determined. If, in a subsequent period, these intra-group transactions are subject to a transfer pricing audit, the tax administration would not be precluded from examining the selection of the transfer pricing method or the way in which it was applied in order to confirm compliance with the arm's length principle. In doing this, the tax administration may also examine what information was actually known or reasonably foreseeable at the time of the transaction.

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

Profit splitting factors

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

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

49. Depending on the circumstances, profit splitting factors might be based on the value of (certain types of) assets or capital, where there is a strong correlation between tangible assets or intangibles, or capital employed, and the creation of value in the controlled transaction. In such cases, care should be taken to ensure reliable and consistent measures of the value of the asset(s) concerned.

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

Example 9

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

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<p>the relative value of each company’s intangible property. Subsequently, the net profits of Company A and Company B are calculated in order to work back to a transfer price</p>	<p>would be based on relative R&D expenses, since these are found to provide a reliable measure the relative value of each company’s unique and valuable intangibles. Subsequently, the net profits of Company A and Company B are calculated in order to work back to a transfer price.</p>
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Example 10 [profit splitting factors]

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

Changes to other parts of the Manual:

Glossary of terms

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

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

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

This text was first considered at the 20th Session and is for approval at the 21st Session

PROPOSED GUIDANCE ON CENTRALISED SALES FUNCTIONS

Note: At the Sub-committee meeting in July 2019 the scope of potential guidance on centralised sales and marketing activities was discussed. In previous meetings members from several countries had requested and supported the inclusion of such guidance. It was agreed that centralised sales functions span many issues that are already covered in the chapter on intra-group services in the current Manual, and that a separate chapter is not warranted. It was further agreed that some targeted and focused text to supplement the existing guidance on centralised services in Section B.4 of the Manual would be drafted and presented for further discussion.

A first draft, dated 12th November 2019, was circulated and discussed at the Sub-committee meeting in Nairobi on 2-3 December 2019. A second draft, dated 26th January, was prepared taking into account comments made, and this was circulated in advance of the Sub-committee meeting in Vienna on 17-19 February 2020. At that meeting the draft was discussed, some small amendments made, and it was agreed to submit the draft to the Committee for first reading at its April 2020 session. This happened at the 20th Session.

The following guidance comprises seven new paragraphs, numbered in this document B.4.2.10.1-7, which are proposed to be inserted following the existing guidance and Example 1 at B.4.2.9-10. **These existing paragraphs, shaded in grey, are included in this document to provide context for the inserted guidance.** No changes have been made to the existing guidance in this section. Although the draft guidance is brief, a reference is included to the new guidance on centralised procurement activities, which is likely to be included at the end of the section, since principles derived from that more extensive guidance may also apply to centralised sales and marketing activities.

Current guidance in UN Practical Manual on Transfer Pricing—to remain unchanged (shaded font)

Centralized services

B.4.2.9. An MNE group will often centralize certain business functions within an associated enterprise operating as a service provider to the rest of the group or to a sub-group of associated enterprises, such as a regional sub-group, for their benefit. A wide variety of services may be centralized in this manner, including both low and high-value-adding services. Depending on the facts, each associated enterprise benefitting from the services provided by a centralized service provider should be charged an arm's length price for the services it acquires. The economic benefit

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is apparent if an associated enterprise would otherwise have to perform the activity itself or engage an external service provider.

B.4.2.10. There are numerous reasons for an MNE group to provide intra-group services on a centralized basis. Services may be provided by an associated enterprise for the rest of the group in order to minimize costs through economies of scale. This may allow the MNE group to increase its profits or improve its competitive position by being able to reduce the prices charged to customers. Centralizing services may allow for specialization within an MNE group which may also involve the creation of centres of excellence. Some MNE groups may centralize services in a regional management company for associated enterprises in a particular geographic region in order to align functional and management responsibilities. In some cases an associated enterprise may not have the skills or resources locally in-house for the service it requires and may rely on specialists that are responsible for providing the same type of services across a wider geographic or functional grouping of entities. Another potential benefit of having centralized services for an MNE group is the certainty that such services will be available when required and that the quality of the services is consistent within the MNE group.

Example 1

An MNE group carries on an airline business in 5 countries (Countries A, B, C, D and E) with the parent of the group being located in Country A. Customers of the airline in these countries are provided with the option of calling staff by telephone to book travel and receive advice where necessary. The MNE group decides to create a centralized call centre for the MNE group to exploit economies of scale. The low cost of telecommunications and the ability to share business information among group members allows for the centralized call centre to be located in any country in which the MNE group operates. The call centre can operate on a 24 hour basis in providing call services to all time zones in which the MNE group carries on business. The MNE group concludes that centralizing call centre functions in its subsidiary in Country E will allow the group to take advantage of both economies of scale and low costs. The call centre services provided by the subsidiary in Country E to the parent company and other group members satisfy the benefit test. Without the call centre the group members would either have to establish their own call centres or engage an independent party to provide call centre services on their behalf.

New draft guidance to be inserted

B.4.2.10.1. In the preceding example of a centralised call centre, a centralised facility operating on behalf of the businesses in each country replaces the individual local facilities for booking by phone in each country. A distinct and relatively small part of the businesses in each country is replaced with a centralised but still distinct part of the business. The change does not affect the fundamentals of the businesses; for example, how the businesses contract with customers, or how the businesses generate demand through marketing strategies. In some situations, however, the centralising of activities can affect the fundamentals of the businesses receiving the services, and those situations can be challenging to analyse for transfer pricing purposes. Depending on the facts, one such situation is that of centralising sales or marketing activities. The following paragraphs provide guidance on some of the factors that are likely to be relevant in analysing

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centralised sales or marketing activities, so that the arrangements actually performed can be accurately delineated and evaluated in the context of the business of the MNE group. Such an objective is common to all transfer pricing analyses, but offshore marketing companies are identified as a flag suggesting further investigation in C.3.3.2.19 of this Manual [page 428], and the attribution of sales and marketing functions and risks to a centralised entity should be carefully analysed, especially if the arrangements are not common between independent enterprises in the industry or the potential for profit shifting is significant because of the taxation regime to which the centralised entity is subject.

B.4.2.10.2. Commercial objectives for centralising sales or marketing activities involve the general aims outlined in B.4.2.10 above, but more specifically can also involve cost-savings (avoiding the duplication of costs in smaller markets by co-ordinating and aggregating activities), co-ordinating marketing activities and developing and exploiting marketing intangibles consistently, standardising processes, prices and terms, responding to regional or global customers that may have similarly centralised their activities, and managing stock levels and warehousing more efficiently. In some cases, a centralised sales company may perform a range of activities: it may be responsible for fulfilling the orders solicited by the local in-market company; the centralised company may determine the sales and marketing strategy, develop and use its own marketing intangibles, assume inventory and pricing risk, and direct the activities of the local in-market company. In other cases, the centralised sales and marketing activity may provide a support function to the local in-market enterprises which remain responsible for performing a range of activities.

B.4.2.10.3. In analysing arrangements involving the centralising of sales and marketing activities, the first task is to understand those arrangements in the context of the business of the MNE group and the nature of the transactions being undertaken. One important aspect may be to distinguish clearly between a centralised sales function and a centralised marketing function. Centralised sales functions may involve the order to cash processes, including centralised administration of invoicing and payments; centralised sales functions may also involve the logistics of getting products to customers, including storage and transport. Centralised marketing functions may involve identifying the market opportunities, differentiating the offering in the market, and creating and maintaining consumer preferences. Either or both functions can be centralised, and a transfer pricing analysis requires clarity about the nature of the relevant functions, the extent to which centralisation of functions has in practice taken place, the identification of risks and attribution of risks to the parties to the arrangements, and an evaluation of the contribution of the activity to how the MNE group generates value.

B.4.2.10.4. Some businesses in which customers can find alternative products without repercussions may be characterised by a greater focus on marketing as a differentiator and contributor to performance. For example, the branded consumer goods sector may require extensive local in-market activities if the business requires very specific local market knowledge and bespoke marketing campaigns to compete with other sellers in the market; there may be differences in similar products around the world because of different consumer preferences in different markets, and there may be differences in sales channels because of consumer preferences or market maturity. In practice, the local in-market company may contribute local knowledge about the market and how to target sales and devise marketing campaigns, may propose sales channels, price points, inventory levels, and product ranges, and may be the only point of contact with customers. In such a case, the centralised sales function may provide support to the in-market

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companies through standardising processes and saving costs on administrative and finance functions by centralising those activities.

B.4.2.10.5. In other sectors, including the commodities sector (or sectors involving commoditised goods), the product may be identical or almost identical in all markets, the customers may be highly specialised and centralised, terms and conditions for contracts may be similarly specialised, inventory levels may be set globally, pricing and other terms may be negotiated centrally, and the sales and marketing strategies may be developed on a global basis, and may be limited if the business is characterised by longer term contracts with a relatively small number of customers. Storage and delivery may be a key aspect of the sales process (particularly for goods that require specialised facilities or processes such as ripening). In such a case, the contribution made locally is likely to be different to the branded consumer goods example, and may be limited to developing or managing a relationship with a small number of customers, whereas the selling activity is conducted by the centralised company.

B.4.2.10.6. A typical evidentiary issue relating to centralised sales and marketing activities concerns the relative decision-making responsibilities of the local in-market company, other associated enterprises such as the producing company, and the company providing centralised services. One aspect may involve which party, the local in-market company, other associated enterprises such as the producing company, or the company providing centralised services, controls significant risks associated with the sales activities through the performance of relevant decision-making (see B.2.3.2.36). Another aspect may involve determining which party performs important functions associated with the development/acquisition, enhancement, maintenance, protection, and exploitation of marketing intangibles (see B.5.3.15-20). In situations where the non-resident centralised sales company is responsible for concluding sales in the local market, then it may be appropriate to consider whether those activities create a deemed permanent establishment under Article 5 of the UN Model Double Taxation Convention.

B.4.2.10.7. The principles found in the extensive guidance on centralised procurement activities, which can be found at the end of this Section, may also be instructive when analysing centralised sales and marketing activities. In particular, this guidance may assist in analysing situations where the local in-market company sells to an intermediary group company.

ATTACHMENT B.6. – SYNERGIES AND PROCUREMENT

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

(First considered at the 19th Session - Approved at the 20th. Included only for context)

PART 1: POTENTIAL REVISIONS TO CURRENT GUIDANCE ON SYNERGIES

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

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

The Document will be renumbered within Part B. There have been no changes of any substance since the 19th Session].

Group synergies and intangibles

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

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

1. MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies among group members which are not generally available to independent

ATTACHMENT B.6 – SYNERGIES AND PROCUREMENT

enterprises. As explained in the section on the theory of the firm, MNE groups are able to minimise their costs through their integration economies, which are not available to domestic firms (see A.2.7). Such group synergies can arise, for example, as a result of streamlined management, elimination of costly duplication of effort, economies of scale, integrated systems, purchasing or borrowing power. Such group synergies are often favourable to the group as a whole and therefore may heighten the aggregate profits earned by group members compared to independent enterprises. In other circumstances, however, integration economies of MNE groups can lead to reduced competitiveness (see A.2.12). The MNE group may not have a competitive edge in performing functions in-house compared to outsourcing functions to specialised firms, the size and scope of corporate operations may create bureaucratic barriers not faced by smaller and more nimble enterprises, or one portion of the business may be forced to work with systems that are not the most efficient for its business because of group-wide standards established by the MNE group.

2. Section B.4.2.21-24 discusses passive association and incidental benefits in the context of intra-group services. The guidance explains that an associated enterprise should not be considered to receive an intra-group service or be required to make any payment when it obtains benefits attributable solely to being part of a larger MNE group. The benefits of association with an MNE group are not a chargeable service for the members of the MNE group. The key feature of this kind of incidental benefit is that it is passive and cannot be attributed to a deliberate concerted action taken by another member of the MNE group. On the other hand, a deliberate concerted action involves one associated enterprise performing functions, using assets, or assuming risks for the benefit of one or more other associated enterprises, such that arm's length compensation is required.

3. Whether group synergies exist, the nature and source of the synergistic benefit or burden, and whether the synergistic benefit or burden arises through deliberate concerted group actions can only be determined through a thorough functional and comparability analysis.

4. The difference between deliberate concerted action and benefits of passive association may be illustrated by the differences in the following scenarios. If a central purchasing manager at the parent company or regional management centre performs a service by negotiating a group-wide discount with a supplier on the condition of achieving minimum group-wide purchasing levels, and group members then purchase from that supplier and obtain the discount, deliberate concerted group action has occurred notwithstanding the absence of specific purchase and sale transactions among group members. Where a supplier unilaterally offers one member of a group a favourable price in the hope of attracting business from other group members, however, no deliberate concerted group action would have occurred. Instead the favourable price is a synergistic effect that may be a comparability factor relating to the economic circumstances of the group member. In the first scenario, the deliberate concerted action of negotiating a group-wide discount is a service that should be appropriately rewarded. However, the benefits of those large-scale purchasing synergies should typically be shared by the members of the group in proportion to their purchase volumes.

5. Another example relates to lower interest costs, as discussed further in Section XX. Company B may benefit from credit terms from third-party lenders because it is part of MNE Group ABC that are more favourable than those obtained by otherwise similar independent enterprises. Third-party lenders may conclude that Company B is less likely to present credit risk because the MNE Group is likely to support Company B and prevent default. However, the third-party lenders have obtained no explicit guarantees from MNE Group ABC. Company B, therefore,

ATTACHMENT B.6 – SYNERGIES AND PROCUREMENT

receives a passive, incidental benefit that cannot be attributed to a deliberate concerted action of any member of the MNE Group ABC. Instead the implicit support is a synergistic effect that may be a comparability factor relating to the economic circumstances of Company B. In contrast, if the parent company of MNE Group ABC, Company A, provides a formal guarantee to the third-party lenders as an inducement to offer enhanced terms to Company B, then Company A would be party to a deliberate concerted action in which it performs functions, uses assets, and assumes risks for the benefit of Company B, such that arm's length compensation is required.

6. The analysis of group centralised procurement activities will often require assessment of group synergies. Assume that MNE Group ABC decides to implement a policy of cost savings by centralising procurement functions in Company P. Company P acts to aggregate purchase orders for raw materials on behalf of group members, and thereby is able to take advantage of volume discounts that arise solely because of the MNE group's aggregated purchasing. The relevant associated enterprises of MNE Group ABC buy the raw materials at the price negotiated by Company P. In this scenario, Company P performs a deliberate concerted action for which an arm's length fee should be paid by the relevant associated enterprises benefitting from the procurement service. However, Company P is not entitled to retain any part of the discounts. Any volume effect on the price of raw materials is contributed by the buying power of the associated enterprises that allow Company P to aggregate their requirements for the goods. The volume benefit should accrue to the associated enterprises contributing the buying power, less the fee payable to Company P.

7. Section B.4.XX provides additional guidance on how to analyse centralised procurement activities, the factors that may affect compensation for those activities, and the transfer pricing methods that may be appropriate.

PART 2: ADDITIONAL GUIDANCE - CENTRALISED PROCUREMENT ACTIVITIES

Introduction

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

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

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

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A preliminary note on cost-savings

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

6. Where evidence of per unit cost reductions is provided by a taxpayer, the impact of any volume effect will need to be considered, but it is important not to jump to the conclusion that the reductions are caused solely or partly by a volume effect. A supplier will not always be willing or able to reduce the price in exchange for higher volumes, and the associated enterprises individually may already have sufficient volume to command the lowest price. In the absence of a published price list, it will be difficult for tax administrations to assess whether additional volume has caused additional discount. There may be countervailing commercial pressures as well that drive a buyer to adopt a multiple sourcing strategy and to spread its volume around multiple vendors and reduce risk exposure, and similarly that may drive a vendor to avoid over-reliance on one customer.

7. Evidence of per unit cost reductions may point not to a potential volume effect, but to the interaction of the procurement activities with the vendor that helps to reduce the vendor's costs or risks which can then partly be passed on to the buyer: for example, a procurement company could be found to take on transport co-ordination functions, or could be found to assume compliance with labelling requirements. Significantly, procurement activities could be found to include arranging for a range of products to be sourced from a particular vendor, some seasonal, time sensitive, and with unpredictable demand, and some predictable items that can be produced throughout the year, so that the vendor can plan production schedules more efficiently and reduce or eliminate down-time and associated costs. Reduction in the vendor's risks and costs in this manner can drive a more favourable price for the buyer. In such a case, volume itself may play little or no part in achieving the cost reductions for the buyer; instead the cost reductions are achieved through the expert co-ordination of both vendor and buyer requirements by the party providing such procurement activities.

8. Measurement of per unit cost-savings is sometimes used in evaluating the fee for procurement activities, as discussed further in paragraph 41. This can be a difficult measurement for tax administrations to analyse. It may be possible to see that in Month 12 an MNE was paying 100 for an item, and that in Month 13 following the introduction of a centralised group procurement company, the MNE was paying 95 for the identical item on the same terms. But as time passes, the relevance of using 100 as the base-line reduces because other factors may have contributed to price changes, and the item may no longer be identical. In such cases, measurement of cost-savings in, say, Month 37 may be presented by the taxpayer based on comparison with a hypothetical price that the MNE would have paid in Month 37 had it not received the services of the group procurement company. The hypothesis will need to be presented rigorously by the taxpayer with supporting evidence, and verification ultimately may be difficult for tax administrations. Thus, where cost-savings are relevant to evaluating a fee for procurement activities they need to be supported by evidence that can be examined by tax administrations. It

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should not be forgotten that procurement activities can provide value in the absence of per unit cost reductions.

9. In practice, the MNE group may monitor and measure in various ways the performance of procurement activities for commercial purposes in order to assess its own effectiveness, and those measures may be instructive in a transfer pricing analysis. Depending on the commercial objectives of the MNE group, such monitoring and measurement may focus on quality, speed, standardising the range of items, finding alternative sources of supply, working capital management through vendor credit terms and inventory levels, order processing costs, production disruption, integrating other divisions or newly acquired businesses, meeting external and internal standards (for examples, ethical trading, traceability, safety), and specific improvement projects to which the procurement function contributes.

Commercial objectives in centralising procurement functions

10. There may be various commercial objectives in centralising procurement activities. A pure volume effect may not be the most important objective, particularly when MNEs in an MNE group may individually have strong buying power. At its simplest level centralising can reduce administrative costs by co-ordinating and aggregating purchase orders, so that instead of, say, 25 associated enterprises in an MNE group, each separately purchasing from, say, 10 suppliers, thereby creating 250 orders each time, the purchase orders are aggregated, so that there is only one order placed with each of the 10 suppliers. However, at this simple level, the individual MNEs continue to determine their requirements, and the central procurement activity helps to manage and reduce the administrative costs of order processing and accounts payable.

11. An additional commercial objective of centralising procurement activities might be to standardise buying terms; it may be that the 25 enterprises had each negotiated different terms with the suppliers in the past, and the oversight of all purchasing that central co-ordination can bring enables a sharing of the best terms for all associated enterprises. The central procurement function remains administrative; it is not itself creating enhanced terms but acting as the vehicle through which the MNEs share information and best practice. In some circumstances, dealing with one buyer may be helpful for the supplier since it is no longer dealing with 25 different buyers and may be able to share efficiencies with the MNE group that arise through reduction in numbers of purchase orders, standardisation of terms, and co-ordinated production scheduling and delivery.

12. In some industries, for example producers or users of energy products, centralising procurement activities may respond to the significant infrastructure costs required to perform the procurement activities. Such costs may involve electronic trading platforms and may also extend to transportation and storage assets. A key commercial objective in centralising procurement activities in such cases is to make the most efficient use of the investment.

13. In other situations, the centralising of procurement activities may be established, or may evolve, to take a more active and extensive role in managing procurement and sourcing for the MNE group with the objective of improving the group's profitability and managing its risks. The role may be directed to enhancing the relationship with vendors, to improving the performance of the associated enterprises requiring the goods or services, or both. A skilled buying team will likely analyse the supply chain and seek to rationalise excessive numbers of vendors without creating unacceptable exposure to a particular supplier, region, or currency; seek to deepen the

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relationship with remaining vendors through collaboration in managing production scheduling, demand forecasting, and specification improvements; monitor quality; select better or alternative sources of supply; and continually assess global trends that may affect availability of supply and prices. A skilled buying team may also seek to understand and anticipate the requirements of the associated enterprises using the goods or services. The buying team may work closely with the production teams or development teams of the associated enterprises so that the buying team can suggest alternative or cheaper components, and will seek to understand and contribute to scheduling forecasts in order to avoid the costs and risks of over-stocking as well as the potentially greater costs and risks of having insufficient supply. In some sectors there are regulatory requirements concerning traceability of items used in producing goods, and there may be consumer interest in sustainability, environmental impact, and ethical concerns which can have consequences for the reputation and ultimate success of the MNE group. The central procurement and sourcing function may have the commercial objective of co-ordinating or leading the efforts of the MNE group in these matters.

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

Evaluating compensation for procurement activities

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

The role and expertise of the procurement services provider

16. Procurement activities cover a range of functions and the particular functions actually performed in a particular case need to be specifically identified and their commercial objectives and contribution assessed. In performing such an analysis, it can be helpful to consider two categories of functions relating to procurement: purchasing and sourcing.

17. In providing a purchasing service, a centralised group procurement company may be instructed by the associated enterprises about their requirements, and the instructions may include specifications for the product or service, identification of the vendors, and parameters for volumes, pricing, delivery scheduling and other terms. In performing such a purchasing function, a group procurement company may provide "execution only," and it may perform a largely administrative function relating to raising purchase orders and managing accounts payable. The role may not require expertise about the products or services procured, the needs of the recipients, or the capabilities of the vendors. The role of centralised purchasing may include relaying revised terms or other proposals to the recipients for approval, but it may not actively seek improvements or

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alternatives. The commercial objectives of a centralised purchasing function may include those outlined in paragraphs 10-11.

18. A sourcing role is more extensive. The role of the centralised procurement company in performing a sourcing function may involve working with the associated recipient enterprises jointly to draw up specifications, to explore alternative specifications, identify potential sources of supply taking into account advantages and disadvantages of particular sourcing strategies, work with vendors to understand their capabilities and options, propose supply schedule and other terms taking into account production forecasts. Such a role may require expertise about the products or services procured, the needs of the recipients, and the capabilities of the vendors. It is not an “execution-only” administrative role, but determines the sourcing strategy, and involves vendor management and demand forecasting. In addition to specialised know-how, such a sourcing activity may use proprietary software tools to evaluate vendors and manage supply scheduling and inventory levels. The commercial objectives of a centralised sourcing function may include those outlined in paragraph 13.

19. Functionality and expertise are greater in a sourcing activity than in an activity that is limited to purchasing. As a result, purchasing and sourcing would generally be more valuable to the recipient enterprises than a purchasing only service, and would be expected to command a higher amount of compensation than that for purchasing alone. Therefore, in evaluating a particular controlled transaction involving procurement activities, it is likely to be useful properly to understand the scope of purchasing activities and the scope of any sourcing activities.

20. Although purchasing functions have been considered separately to sourcing functions to highlight differences that may affect levels of compensation, in practice activities may include aspects of both categories. For example, a purchasing function may include aspects of sourcing activities with the result that the activity is not simply “execution-only,” and would thus generally be more valuable to the recipient enterprises in such a case than an activity limited to purchasing.

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

21. It is important to determine through the accurate delineation of the actual transaction whether the goods or services procured by the centralised procurement company constitute core spend or non-core spend for the recipient associated enterprises. Non-core spend, sometimes referred to as indirect spend, covers goods and services that support the businesses of the recipient associated enterprises and are not themselves converted into a finished item or resold. Core spend, sometimes referred to as direct spend, involves items that are converted or resold in the course of the business of the recipient associated enterprises.

22. In the case of non-core spend for the recipient associated enterprises, for examples, stationery, office equipment, telephone services, vans, media space, an important factor that needs to be tested in accurately delineating the actual transaction is that the goods or services are unlikely to be a key risk for the recipient or a significant contributor to business performance. The goods and services are likely to be available from a range of suppliers, and so the pricing is already competitive. Specifications are likely to be relatively standardised and options for changes or improvements may be limited. The function of the centralised procurement company in the case

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of non-core spend may be largely that of a co-ordinator and aggregator, with the main commercial benefits being the combining of purchasing power across the MNE group and efficiencies in reducing administrative costs for the MNE group.

23. However, in the case of spend on core business-critical items, for examples, lithium for a battery manufacturer, certain ingredients for a food manufacturer, energy for a smelter, an important factor that needs to be tested in accurately delineating the actual transaction is that the goods or services may represent a significant contribution to business performance and be associated with significant risks. The items may have very limited sources, availability of supply may be unpredictable, prices may be volatile, and there may be particular specifications to be met or worked around. The function of the centralised procurement company in the case of core spend may require specialised expertise and may involve mitigation of critical business risks for the recipient associated enterprises.

24. These factors suggest that procurement of goods and services constituting business critical core spend for the recipient associated enterprises would generally be more valuable to the recipient enterprises than procurement of goods and services constituting non-core spend, and, subject to thorough determination of the actual functions performed, assets used, and risks assumed in a specific controlled transaction, would generally be expected to command a higher amount of compensation than that for procurement of indirect spend.

Risks assumed by the group procurement company

25. Arguments are sometimes made that a centralised procurement company should have a high level of compensation because of the risks it claims to assume. While it is the case that the assumption of increased risk would be expected to be compensated by an increase in the anticipated return, careful attention may need to be paid when examining risk assumption by the associated enterprise performing centralised procurement activities.

26. It may be asserted that a centralised procurement company assumes, for example, risk associated with holding inventory (which may involve the risk of changes in the value of inventory owing to market price changes or obsolescence, or the risk of additional costs because of overstocking), since it is the contracting party that buys the goods or services procured and is the contracting party that sells them to the recipient associated enterprises. The insertion of the centralised procurement company in the flow of goods or services is not likely to be a typical arrangement given the potential for additional cross-border movements and complexities of customs duties and additional transaction costs. In addition, vendors may require guarantees to be provided by the parent or associated enterprises in order to sell directly to a group procurement company that may present concerns about creditworthiness; in such a case, there may be additional intra-group transactions to be examined. Where inventory is determined to be owned by the centralised procurement company, evaluation of the risk is required. It will be relevant to determine whether the group procurement company takes “flash title” only under back-to-back arrangements with the associated recipient enterprises, and thus significantly reducing or eliminating its inventory risk. In practice the recipient associated enterprises may compensate the centralised procurement company for any additional costs, thus insulating the centralised procurement company from the impact of inventory risk. It will also be relevant to consider whether the supply arrangements with the vendors are flexible so that purchase volumes can be reduced as demand falls, thus reducing or eliminating risk. Nevertheless, if the centralised

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procurement company could suffer additional costs as a result of the impact of inventory risk it contractually assumes, then control of risk under the guidance in section B.2.3.2.23-46 (pages 87-100) needs to be determined. If the centralised procurement company does not control the inventory risk it contractually assumes because, for example, it does not determine quantities purchased, stocking levels, production scheduling, or manufacturing volumes, then it is unlikely to be allocated the risk under that guidance for transfer pricing purposes.

27. A centralised procurement company may assume contractually a range of other risks. In such cases a similar analysis to that described above under the guidance in section B.2.3.2.23-46 (pages 87-100) is required. A procurement company could claim to assume price risk by undertaking to guarantee a certain range of prices for the recipient associated enterprises, or to assume volume risk by undertaking to supply a certain volume. However, such risks may be reduced or eliminated if the terms agreed with the vendors in practice pass price or volume risk back to the vendors. A claim that a centralised procurement company is exposed to the full impact of cyclical demand and price risks should be examined carefully, as attention should be paid to whether it has the expertise to evaluate the risk, makes decisions in relation to the risk, and has the financial capacity to bear the risk.

28. Although the group procurement company may not assume risks associated with the goods and services procured, it will be necessary to determine whether the group procurement company performs control functions relating to risks assumed by associated enterprises, since such risk control functions need to be taken into account in determining the appropriate amount and form of the compensation (see paragraphs B.2.3.2.43-45 in particular, page 98). In the case of the sourcing of core, business-critical items, in particular, the accurate delineation of the actual transaction could show that availability of supply is a key risk for the MNE group and that the group procurement company directly mitigates disruption risk through developing reliable sources of supply or exploring alternative specifications.

29. Thus, as a general matter, recipient associated enterprises would be prepared to pay more for a procurement service that reduces or eliminates their risks, but care needs to be taken to ascertain that risks have been mitigated for the recipient associated enterprises, and that the group procurement company contributes to such mitigation by performing risk control functions.

30. A centralised procurement company may have its own risk associated with developing and maintaining proprietary tools, systems, know-how, and investment in physical assets.

Procurement from associated enterprises

31. Until now in this guidance it has been assumed that the most typical form of intra-group procurement activities involves procurement from independent vendors on behalf of recipient associated enterprises. It is possible, however, that an MNE group may use a group procurement company to purchase from other associated enterprises in the group. The potential for reducing transaction costs and increasing efficiency through co-ordination and aggregation could apply in such a case for the MNE group similar to the situation described in paragraph 10. Instead of dealing with 10 independent suppliers, as illustrated in that paragraph, the group procurement company could deal with 10 associated enterprises, but the efficiency effect of consolidating the ordering process and reducing the number of purchase orders continues to apply.

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32. However, a claim that a group procurement company performs more than an administrative role when acting as an intermediary in purchasing from associated enterprises may not be supported by the evidence. A claim that a group procurement company performs a sourcing role, involving the selection and management of vendors which are associated enterprises, is likely to be difficult to substantiate in the case of an integrated MNE group in which associated enterprises are aware of the capabilities of each other and are organised to fulfil a specific role in the MNE group's supply chain. That supply chain may benefit from other centralised management activities, but any payment for finding a vendor that is already found and is part of the design of the MNE group's supply chain would seem difficult to justify.

Pricing methods

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

34. Given the range of activities that may be involved in procurement and sourcing activities, it may not be surprising that a range of pricing structures are seen in arrangements with independent outsourced procurement providers. These range from a fee related to the provider's input costs, which may be particularly appropriate where the decision to outsource is motivated by a desire to reduce headcount and transfer people and associated costs to the outsourced provider; fees which are set as a percentage of managed spend (similar to a commission), and which may encourage investment by the service provider; to fees which are designed to incentivise the outsourced procurement provider by sharing gains. In practice hybrid fee structures may be seen, combining a commission on managed spend with a gain-share element.

35. When determining the pricing for centralised procurement activities within an MNE group, transfer pricing methods can broadly mirror such industry pricing structures. Pricing based on costs, plus an arm's length mark-up under the Cost Plus Method or TNMM, may be appropriate; or comparable commission rates under a CUP Method may be applied; or a form of benefits analysis may be constructed which requires the gains achieved as a result of the procurement

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activities to be measured and which then shares them between the centralised procurement company and the associated recipient enterprises.

36. As in any transfer pricing analysis, the appropriateness of the method depends crucially on the facts and circumstances of the controlled transaction and the reliability with which the method can be applied. These matters are discussed further below, but before doing so it is useful to remember that the application of one method rather than another method can yield significantly different results, especially if applied over a number of years. Take the following example of a centralised procurement activity, which shows the costs incurred in performing the activities (“own costs”) and the costs of the goods or services procured through those activities (“managed spend”):

Table 1

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

37. For the purposes of the example, it is assumed that a Cost Plus Method determines a mark-up of 10% and that a CUP determines a commission on managed spend of 2%.

38. In this example, there may have been some over-capacity or some investment in technology by the centralised procurement company in its initial year that meant a CUP method results in a loss. However, as managed spend ramps up, the gap between profits under the Cost Plus Method and profits under a CUP Method widens considerably. One method determines a 10% mark-up on costs, the other method results in a 320% mark-up; one method determines a commission of 2%, the other method results in a commission of less than 1%. Expressed another way, the recipient associated enterprises in Year 3 pay \$32m to the centralised procurement company under one method and \$11m under the other method. A high standard of evidence and analysis is usually required, therefore, to demonstrate that the centralised procurement company contributes sufficiently to business outcomes to justify the payment of that additional \$21m. Because the choice of method can lead to widely different outcomes, disputes between taxpayers and tax

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administrations about the pricing of centralised procurement services may focus on differences of view about the appropriate method.

39. A Cost Plus Method or TNMM is likely to be an appropriate method where the procurement activities are mainly purchasing rather than sourcing, and any sourcing activity is limited in scope or relates to non-core spend, largely execute instructions from the recipient associated enterprises, and do not assume risks or perform risk control functions relating to the goods or services procured. In such a case the value to the MNE group is mainly efficient deployment of resources and a cost-based fee may appropriately measure that value. The arm's length mark-up may reliably be based on comparable independent service providers. As for many intra-group services that require to be benchmarked against independent services providers, identical activities may be hard to identify. Nevertheless, it is expected that independent services providers can be identified that provide broadly similar administrative services that would provide a sufficiently reliable range of mark-ups. The Cost Plus Method should not necessarily be rejected even if the activities are more extensive and require greater resources, greater expertise, and perhaps investment in tools and software. In such a case, the cost base for the centralised procurement company is likely to be greater, and a mark-up on that greater base will generate a higher fee.

40. However, where the procurement activities involve significant sourcing activities, relate to core goods and services, include business-critical decisions, and involve some risk assumption or performance of risk control functions, then the activities affect business outcomes and the value to the MNE group may correlate to revenues or profits. The reliability of comparing the centralised procurement company to independent service providers under a Cost Plus Method may be reduced. Instead, the application of arm's length commission rates under a CUP Method is likely to be appropriate.

41. In other situations, there may be differences between the uncontrolled and controlled procurement activities; for examples, the items procured may relate to non-core spend rather than to core, business critical items, and the relationship between rates of commission and volumes may not be reliably ascertained. The reliability of the application of a CUP Method can be improved in these situations by using the concept that at arm's length recipient parties will be prepared to pay a fee if they expect to receive benefits from the outsourced procurement services provider that are greater than the fee. In practice, therefore, the information about commission rates resulting from a CUP Method can be interpreted and tested for reasonableness by an approach which seeks to identify the benefits derived from the procurement activities, and to share them between the centralised procurement company and the recipient associated enterprises based on their respective contributions, including any risk control functions. The identification of benefits should not be speculative or created for the transfer pricing analysis, but should be rooted in commercial measures that the MNE group uses to assess performance (see the illustrations in paragraph 9). If benefits are not measured by the MNE group independently of a transfer pricing analysis, then this may suggest that the benefits are not commercially important and the activity is not one that makes a significant contribution to business performance (and consequently may suggest that a Cost Plus Method is more appropriate). Care should be taken in such an analysis first to measure and deduct benefits arising from aggregation of volumes, which should be allocated to the associated enterprises contributing the buying power. The resulting share of benefits can corroborate commission-based fees and narrow the range of fees potentially identified through a CUP analysis. Evidence of gain-share agreements between independent parties can be difficult to use if it is not

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possible reliably to determine how the parameters for measuring the gain have been set in uncontrolled arrangements, and how those parameters might be adapted to apply to the controlled arrangement.

42. The following is an example of how the results of a CUP Method can be interpreted, tested for reasonableness, and corroborated by an approach which shares benefits. Assume that a centralised procurement activity of Company A is responsible for sourcing and for managing the purchasing process for the core spend of a related manufacturing company, Company B. Company B purchases the goods directly from the suppliers sourced by Company A, and so any price discounts attributable to Company B’s volume accrue directly to Company B. Both companies are part of the ABC Group. The spend managed by Company A represents 80% of Company B’s costs of goods. Company A incurs costs of 5 in performing its procurement activities. Company B sells its finished products to third parties; the products are technologically advanced, but the manufacturing process itself is not unique. Assume that the comparability analysis has determined that Company A’s activities contribute significantly to the business performance of Company B and involve Company A using its know-how to work closely with suppliers to improve specifications, monitor quality, evaluate alternative sources of supply, and ensure uninterrupted supply. Recently the ABC Group has made public commitments to recycle and re-use components, and Company A has led the initiative with suppliers to make the necessary changes and achieve the Group’s targets. The management of ABC Group monitors closely the performance of Company A through key performance indicators of Company B’s business and risks including inventory levels, production down-time through supply problems, product failures in quality checks, and recycling targets. Good performance by Company A can positively contribute to the revenues, costs, and therefore profits of Company B; poor performance risks adversely affecting the profits of Company B.

43. Assume further that a CUP Method is appropriate. Potentially comparable commission rates in uncontrolled transactions are identified that provide a range between 1% and 7% of the managed spend. There are differences between the potential comparables and the activities of Company A, particularly because the comparables tend not to procure business-critical items nor assume responsibility for delivering key initiatives in the way that Company A does, and it is not possible reliably to determine how volume may affect the commission rates.

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

Sales to third parties			1000	
Cost of Goods	(500)			Managed Spend by Company A is 400. Potential CUP range of 1%-7% equates to a procurement fee of 4 to 28
Other Costs	(300)			
Total Costs		(800)		
Profits before procurement fee			200	

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		<i>Application of corroborating benefits share approach as described in the following paragraphs.</i>		
		(80)		Benchmarked return to manufacturing
			120	Residual profits attributable to Company B's technology and Company A's procurement activities
		(5.25)		Routine procurement fee to Company A (own costs of 5 plus a mark-up of 5%)
Residual Profits			114.75	
Hypothetical technology royalty of 10%			(100)	Company B has developed the technology embedded in the product. A relief from royalty valuation approach determines the hypothetical royalty payments that would be saved through owning the asset, as compared with licensing the asset from a third party.
			14.75	Profits earned by Company B relating to procurement activities of Company A

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

46. How the resulting profits of 14.75 should be shared between Company A and Company B may be possible to evaluate from the metrics ABC Group uses to monitor Company A's performance. This would likely require converting to an impact on profits the stated performance measures relating to inventory levels, production down-time through supply problems, product

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failures in quality checks, and recycling targets. Conversion would likely require assumptions to be presented about base-line performance and placing a value in terms of profits on variations to the base-line. Such an analysis may be informative but may not be definitive.

47. Failing that some reasonable estimates need to be made in order to share the resulting profits of 14.75 between Company A and Company B. The analysis would immediately suggest that paying 28 to Company A (a commission of 7% at the top of the CUP range on managed spend of 400) would attribute more than the residual to procurement activities (Company A is already attributed a routine return of 5.25, and so an additional 22.75 to arrive at a total fee of 28 would allocate nearly twice the residual to Company A). Instead the analysis suggests that a commission rate nearer the lower end of the potential CUP range is more appropriate. If all the residual of 14.75 were allocated to Company A, then the maximum commission would be 5% (calculated as the residual of 14.75 together with the routine return of 5.25 resulting in a procurement fee of 20, which is 5% of managed spend of 400). Paying 8 to Company A (representing a commission of 2.0% on the managed spend of 400) is towards the lower end of the CUP range, but would seem to represent a more reasonable share of residual profits between the two companies given the fact that it is Company B that bears the majority of risks. Under the benefits share Company A has already been allocated 5.25 and the additional 2.75 represents approximately a 20/80 split of the residual profits of 14.75 in favour of Company B.

48. Note that a fee of 8 in this example represents a mark-up of 60% on Company A's own costs of 5. Such a mark-up is significantly in excess of, for example, the rate of return for Company B's manufacturing activities. Such a relatively high mark-up does not undermine the outcome of this example. The example is intended to be an illustration of the guidance in paragraph 40 which states that "where the procurement activities involve significant sourcing activities, relate to core goods and services, include business-critical decisions, and involve some risk assumption or performance of risk control functions, then the activities affect business outcomes and the value to the MNE group may correlate to revenues or profits. The reliability of comparing the centralised procurement company to independent service providers under a Cost Plus Method may be reduced. Instead, the application of arm's length commission rates under a CUP Method is likely to be appropriate." The example shows how, in circumstances where a CUP Method is likely to be more reliable than a Cost Plus Method, the potentially wide ranges of commission rates under a CUP Method can be narrowed, tested for reasonableness, and corroborated through the application of an approach which shares benefits.

49. In summary, replication of pricing structures used by independent outsourced procurement services providers is rarely an option that can be adopted in practice because of the difficulties in finding such data, in interpreting it reliably in the context of the controlled arrangement, and in estimating appropriate adjustments. The Cost Plus Method or TNMM can be applied in most cases, even in cases where the centralised procurement company provides expert services and employs know-how and proprietary tools. Where the activities contribute significantly to commercial performance of the MNE group and involve control of economically significant risks for the MNE group, other methods may be appropriate. Commission rates in third-party arrangements may be available, with the result that a CUP Method can reliably be applied. Indicative commission rates under a CUP Method may be corroborated by an approach which shares accurately measured commercial benefits between the group procurement company and its associated enterprises. Reasonable estimates can be made under a benefits share approach to

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interpret and test the appropriate positioning in the range of commission rates indicated under the CUP Method.

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

Extended example

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

Assumed facts of the example

52. An MNE group involved in the manufacture of food products has centralised procurement activities in two companies, Company A, based in Europe, and Company B, based in Africa. The operations of the two companies are different, as described below, and lead to different conclusions about the application of reliable pricing methods.

53. Company A employs 50 personnel and it operates to enhance standardisation of products and services supplied to the group by independent vendors, and to provide better oversight and control of costs. Analysis shows that about 60% of the spend it manages on behalf of the group involves non-core spend relating to procurement of packaging, logistics services, production machinery, information technology and communication equipment and services, and office equipment and supplies. In fulfilling its activities in relation to spend on non-core items it liaises with other group companies to understand their needs, sources and selects vendors, develops relationships with vendors, and negotiates terms. In practice packaging vendors regularly communicate directly with the group's Head of Development and also with production personnel located in the group's manufacturing plants to discuss innovations, cost reductions, and regulations. As a result, the role of Company A in relation to procurement of packaging is to place orders to already agreed specifications and with already selected and known vendors. The group

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recently experienced supply problems following a change in its supplier of logistics services following a tendering process organised by Company A. In accordance with the group's management controls, the decision to approve the new supplier was taken by the parent company with reference to analysis provided by Company A. The remaining 40% of the spend it manages on behalf of the group relates to core spend on food ingredients. However, for these items Company A acts as a co-ordinator and aggregator of orders, as notified by other group companies, and performs the administrative functions of order processing and accounts payable. Company A assumes no risk in relation to the goods and services it procures and does not control significant risks. The performance of Company A is measured by its management on the basis of its order processing costs.

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

Interpretation of the assumed facts for transfer pricing purposes

55. Company A performs a useful function for the group, but it would not seem to be a highly valuable one that contributes significantly to business performance. Company A performs an "execution-only" administrative function in relation to spend on business-critical core items, based on decisions made elsewhere in the group. In relation to spend on non-core items, these are not business-critical items, they are largely standardised and can be sourced from a range of readily identifiable suppliers competing on price. The fact that a new logistics services supplier caused supply problems for the group is not something that Company A is responsible for, assuming its organisation of the tendering process was not negligent. Where deep knowledge of the products sourced is required, in the case of packaging, Company A has no role, except to process orders.

56. If Company A were compensated through a commission fee (by reference to a percentage of spend under management) based on an application of a CUP Method that resulted in profits many multiples of its own cost base, then in the absence of further evidence concerns would arise about why its activities justify such a valuation. There would also be concern in the absence of appropriate evidence if compensation for Company A included a share in savings made by the MNE group based on its activities. The performance of Company A is not measured by

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management by reference to savings, the calculation of any savings would require a high standard of evidence, and Company A does not seem to have any specialised input or control any risks that would justify a sharing in any savings in the event that they could be reliably measured. A Cost Plus Method seems more likely to be appropriate on the facts presented, subject to the reliability with which the method can be applied in any given case.

57. Company B is a smaller operation than Company A in terms of headcount but it concentrates on business-critical aspects that can directly affect group profitability. Company B is deeply involved in developing sources of supply for core items and in working with its associated production companies in forecasting and meeting their demand. It helps to control economically significant risks for the group through influencing continuity of supply and resistance to price volatility, and the group measures its performance in managing these risks.

58. If Company B were compensated through a fee based on its costs plus a mark-up benchmarked by comparison with independent companies, there might be concerns about the reliability of the comparison, and particularly whether the potentially comparable independent companies take responsibility for the sourcing of core, business critical items for their clients. The outcome of a Cost Plus Method may understate the value created by Company B as measured by the MNE group. On the facts presented, it is more likely that a method which takes into account the contribution to value by Company B would be appropriate. Commission rates in third-party arrangements may be available, with the result that a CUP Method can reliably be applied. Indicative commission rates under a CUP Method may be corroborated using an approach which shares benefits based on management's commercial measurements of savings.

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*[Note : This text was largely approved at the 19th Session, after first consideration at the 18th Session. Already approved text is in shaded font. Para 9.4 was approved at the 20th Session. **The numbered examples, beginning after para. B.9.2.1.9. and then at various place were first considered at the 20th Session and up for final approval at the 21st Session.**]*

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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:

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- 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.).¹

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

¹ This chapter does not discuss performance guarantees

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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

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with a low or insufficient credit rating, to improve the terms and conditions of the loan (e.g. to reduce the interest expenses) of the associated group company. Intercompany guarantees come in many forms and are discussed in more detail in Chapter 9.4 *infra*.

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

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

B.9.1.2.7. Another common type of intra-group financial transaction is captive insurance. A parent group entity may create a licensed insurance company to provide coverage for the participating MNE group entities. The main purpose for doing so is to avoid using third party insurance companies, which have volatile pricing, and may not meet the specific needs of the company. By creating their own insurance company, the parent company can create stabilized premiums, reduce their costs, insure difficult-to-insure risks, have direct access to reinsurance markets, and increase cash flow. When a company creates a captive, it is indirectly able to evaluate the risks of subsidiaries, write policies, set premiums and ultimately either return unused funds in the form of profits, or invest them for future claim pay-outs. Captive insurance companies sometimes are also set up to insure the risks of the group's customers. This is an alternative form of risk management. This chapter on financial transactions does not discuss captive insurance transactions in any detail.

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

B.9.1.3. Common types of group financing departments/entities

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

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

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

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

B.9.1.3.3. The category of treasury department/entity that renders the specific financial transactions that are in place may be relevant and provide an initial indication of the most appropriate method to be used to assess the arm's length nature of the intercompany transactions. To determine an arm's length remuneration for services rendered an accurate delineation of the actual transaction (including a functional analysis) is required. In this respect reference can be made to Chapter B.4. on Intra Group Services. Treasury departments/entities operating as service centres are typically remunerated by applying the CUP method, the cost-plus method, or the TNMM based on cost. Treasury departments/entities operating as profit centres, instead, are typically remunerated based on a pricing the various transactions allocating the credit risk of the transactions to the treasury department. Consequently, the 'spread' between costs of funding and return on cash invested will be mainly allocated to that treasury department/entity. To determine the arm's length remuneration for financial transactions such as loans and intercompany guarantees, reference is made to chapters B.9.3. and B.9.4. infra. Moreover, the 'substance' of these centralized activities generally requires careful review as well and are an important focus of the accurate delineation process.

B.9.1.4. Corporate income tax approaches addressing MNE financing decisions

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

B.9.1.4.2. To reduce the base erosion effect of debt financing and the relevance of the tax factor in choosing between equity and debt financing, some countries have made the tax policy choice to introduce in their domestic tax laws measures aimed at either reducing the advantage of debt financing or increasing the advantages of equity financing. These measures can be broadly grouped into General Anti-Avoidance Rules (GAARs) and Specific Anti-Avoidance Rules (SAARs). For a more in-depth discussion on the specific available measures to counter excessive interest deductions claimed by residents, reference is made to the UN Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest and Other Financing Expenses.² As discussed in the aforementioned Practical Portfolio, measures³ 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).⁴

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.⁵ 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

² Prepared by Professor Brian J. Arnold, Senior Adviser, Canadian Tax Foundation, Toronto, Canada and Peter Barnes, Duke Center for International Development, USA.

³ 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.

⁴ 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.

⁵ As recommended by the OECD BEPS Action 4 Final Report.

under domestic law, since both sets of rules might address similar issues and denying deductibility of similar expenses.

B.9.2. The application of the arm’s length principle to financial transactions (in general)

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

B.9.2.1. The arm’s length nature of intra-group financial transactions

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

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characteristics (and possibly together with additional available evidence or conduct of the parties) may lead to the conclusion that the intercompany financial transaction is not a loan. In that case, it may be that the financial transaction for transfer pricing purposes ought to be treated as something other than a loan. This conclusion arguably does not necessarily affect the civil law or common law denomination of the financial transaction, or its classification for accounting purposes, however. It only affects the transfer pricing analysis. Similar to the first scenario, if the facts and circumstances of the transaction available for review lead to the conclusion and decision that the transaction is commercially irrational, the financial transaction may be disregarded as an intercompany loan for transfer pricing purposes. The thirdly scenario involves the same process as the second scenario of determining the characteristics of the financial transaction. However, in this third scenario, it is also examined whether it is possible to conclude that the intercompany transaction in its entirety is not a loan, but (arguably only) part of it could be treated as an intercompany loan. Relevant evidence might for example include a debt capacity analysis of the borrower. In that case, it may be that the financial transaction for transfer pricing purposes gets treated partly as a loan and partly as something other than a loan such as a contribution to equity (see also the guidance in paragraph B.2.3.1.8.). Also in this third scenario, this conclusion and decision arguably does not necessarily affect the civil law or common law denomination of the financial transaction or classification for accounting purposes, however. It only affects the transfer pricing analysis. Furthermore, also in this third scenario, if the facts and circumstances of the transaction available for review lead to the conclusion and decision that the transaction as a whole is commercially irrational, the financial transaction may be disregarded as an intercompany loan for transfer pricing purposes. Before concluding and deciding to bifurcate an intercompany financial transaction, tax authorities would be expected to have conducted a detailed analysis of the respective associated parties, including consideration of the purpose of the loan, economic circumstances, business strategies, creditworthiness, debt capacity and security offered etc. as outlined in paragraph B.9.2.1.5. below. In all three scenarios mentioned above, the treatment of the transaction as something other than a loan would for tax purposes, lead to a limitation in the deductibility of interest expense (entirely or partially) and not necessarily imply a characterization of the transaction as something else (e.g. and equity instrument).

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

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

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- Contractual terms.⁶ 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;
 - (d) whether the amount of financing extended is secured by collateral, a guarantee or unsecured. This will impact the chances of repayment of the funding extended by the lender;
 - (e) the currency in which the loan is extended (and must be repaid) may be relevant;
 - (f) the status (subordination or preferred status) of the lender with respect to other creditors. Subordinated debt is debt that is ranked behind that held by secured lenders in terms of the order in which the debt is repaid. A creditor holding subordinated debt has a lower priority for the collection of its debt from its debtor's assets than a creditor with a preferred status; and
 - (g) convertibility of the funding (for example the right to convert the funding from debt into equity) for the borrower or lender will be relevant, if considered.
- Functional analysis: This analysis is relevant to determine what functions are performed by the respective parties (borrower and lender) in relation to the financial transaction. Facts and circumstances that may assist in determining the functions and responsibilities of the parties to the financial transaction may include:
 - (a) whether the debtor can obtain credit/funding from other sources (possibly including consideration of the debt capacity of the borrower);
 - (b) the (credit and other) risk of the lender in providing funding to this borrower;
 - (c) who conducts the monitoring of ongoing compliance with the terms of the funding agreement;
 - (d) for the borrower it could also include consideration of functions relating to ensuring availability of funds to repay a loan when due, i.e. considering the source of funds for repayment of the financing obtained;
 - (e) the (intended/actual) use of the funds/financing provided to the borrower;
 - (f) it may also include considering the purpose of the financial transaction in the context of the parties' businesses, what assets may be used and what risks are assumed in relation to the financial transaction and how those risks are controlled. The above analysis should consider

⁶ It should be noted that the listed contract clause examples are not exhaustive.

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“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

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in B.9.2.1.2. above, the arm's length principle may be applied to characterize an intra- group financial transaction as being different from that which was initially presented by the taxpayer.

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

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

Example 1: accurate delineation of the actual transaction (provision of funds)

Borrowing Company, BCo, receives funds under a loan agreement from Lending Company, LCo. BCo and LCo are associated enterprises. The loan agreement does not include a maturity date, no security is provided, and interest is contingent on specified levels of profits being achieved by BCo. While these features on their own should not be taken as indicating that the advance of funding is not a loan, on further examination of the facts, it is found that BCo uses the advance to fund the development of a new business concept, that its existing business is weakening, and that both its existing and new businesses are not projected to be able to generate sufficient cashflows over a relevant period to service the loan, and that, consequently, lower amounts of interest will in fact be paid than provided for in the agreement.

The guidance in B.9.2.1.3 is relevant to this example. Some features of the arrangement suggest hallmarks of equity rather than debt, and, together with the analysis of all the circumstances (e.g. BCo's businesses), may lead to a determination that for transfer pricing purposes the arrangement might not be delineated as a loan, with the result that interest deductions would be denied or restricted. Moreover, even if the arrangement is delineated on the evidence as a loan, the commercial rationality of the transaction might be questioned and prevents determination of an acceptable price. In particular, it is doubtful that BCo and a third-party lender would have been able to agree terms for a loan given the very high level of risk for the lender. This evidence may lead to the determination under the guidance of B.2.3.1.4 – B.2.3.1.9 that the loan arrangement might not be recognised as an interest-bearing loan for transfer pricing purposes.

Example 2: accurate delineation of the actual transaction (loan recognition)

AE Co 1 is organized in Country A where it maintains an office and has numerous employees. AE Co 1 engages in a manufacturing business in Country A. It acquires raw materials from unrelated suppliers located in Country C. Before the events described below, raw materials purchased by AE Co 1 were typically shipped from suppliers in Country C to AE Co 1's manufacturing facilities in Country A via independent shipping companies.

After thorough review of alternatives, AE Co 1's management concludes that it could reduce its costs by commissioning the construction of a specially designed vessel and by using that vessel to meet its raw material shipping needs rather than relying on independent shipping companies to transport purchased raw materials. AE Co 1 commissioned a design firm to prepare a unique vessel design suited to AE Co 1's specific needs and identified an unrelated construction firm in Country C to build the vessel.

After the construction contract was negotiated by AE Co 1 employees, but before it was executed, AE Co 1 registered AE Co 2 in Country C. AE Co 1 contributed the minimum statutory capital under Country C law of \$1,000 to AE Co 2 in exchange for 100 of \$10 par AE Co 2 shares. AE Co 2 was to become the party contracting for the construction of the new vessel, and upon completion of the vessel would become the vessel's owner and the shipper of record for all of AE Co 1's raw materials procured from suppliers in Country C.

Immediately after AE Co 2 was registered, AE Co 1 entered into a loan agreement with AE Co 2 in which AE Co 1 agreed to advance \$100 million dollars to AE Co 2 as required to (i) fund AE Co 2's obligations to the construction firm under the construction contract and (ii) fund AE Co 2's day to day operating expenses during the period the vessel was under construction. The loan agreement did not call for AE Co 2 to make any periodic interest payments. The loan agreement provided AE Co 1 with the option to convert the debt obligation to additional equity shares of AE Co 2 at a conversion price of \$10 per share at any time within 5 years. The agreement also permitted AE Co 2 to retire the debt at any time within three years of the execution of the loan agreement in exchange for a payment of \$105 million. AE Co 1 advanced the \$100 million loan amount entirely from its own internally generated funds. Funds were advanced to AE Co 2 during the year following execution of the loan agreement as the funds were required by AE Co 2 to make payments to the construction firm or for other operating expenses. AE Co 1 did not borrow from any other party to finance the loan.

At the same time as the loan agreement was executed, AE Co 2 signed the construction agreement. In conjunction with the execution of the construction agreement, AE Co 1 executed a detailed written guarantee of AE Co 2's obligations under the construction agreement in favor of the construction firm. The construction of the vessel was completed on schedule and the vessel was placed in service by AE Co 2 one year after the loan agreement and construction agreement were signed. At the time it was placed in service, the vessel had a market value of \$110 million.

At the end of year 3, AE Co 1 exercised its option to convert the entire loan principal to additional equity shares in AE Co 2. AE Co 2 never made any payment of principal or interest on the loan to AE Co 1.

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Countries A and C conducted a simultaneous audit of the tax returns of AE Co 1 and AE Co 2 for the three-year period following execution of the construction agreement and loan agreement. In the course of the audit, Country A tax authorities suggested that the \$100 million advance should properly be characterized as a loan and that a transfer pricing adjustment should be made to attribute arm's length market rate interest income to AE Co 1 in each of the three years under audit. Country C tax authorities took the position that the advance should be accurately delineated for transfer pricing purposes as a contribution by AE Co 1 to the equity of AE Co 2 from the outset and that no interest payments to AE Co 1 should be imputed under transfer pricing rules.

In seeking to resolve the differences of view between the tax authorities of countries A and C, and in determining whether the advance of funds from AE Co 1 to AE Co 2 should be treated wholly or in part as interest-bearing, the following matters are likely to be some of the relevant considerations:

(i) are there features of the arrangements in their totality that suggests there were commercial pressures or legal requirements for the party to the construction contract to be located in the same territory as the construction firm, and that AE Co 2 was created as the proxy in Country C for AE Co 1 in order to fulfil these requirements?

(ii) are there features of the advance that indicate whether the advance has hallmarks of debt or equity? Relevant considerations might include the stated absence of interest requirements or repayment terms, the lack of interest payments, and the convertibility option. What evidence exists about circumstances and motivation in Year 3 that resulted in conversion?

(iii) what is the debt capacity of AE Co 2, that is whether a third party would have provided a loan to AE Co 2 in the circumstances described? Relevant matters might involve consideration of the potential future cashflows arising to AE Co 2 from its chartering of the vessel to AE Co 1 upon completion that may be taken into account by third-party lenders, including the contractual rights to such cashflows, the length of the future period over which they may be expected to arise, the risk that they might not materialise, the potential for alternative chartering, and the risk that the completion date may be delayed (with the result that the cashflows are deferred). It may also be relevant to consider the security that may be taken into account by third-party lenders represented by the work in progress of the vessel at stages of construction as well as by its fully completed status. The special design of the vessel to meet the particular needs of AE Co 1 may affect its perceived security valuation.

(iv) what are the risks of additional costs under the construction contract? Although AE Co 1 has provided a guarantee to the construction firm, this provides the construction firm with some protection against non-payment. The guarantee does not mean that, in an arm's length situation, AE Co 1 would not seek to recover additional amounts from AE Co 2, potentially leading to the need for AE Co 2 to raise additional funds. The inability of AE Co 2 to raise additional funds could increase the risk of default. Should risks of cost overruns be factored into the debt capacity of AE Co 2, or is the construction contract a fixed price contract? Are potential delays in completion subject to penalties payable by the construction firm which would help to offset the delays in commencing chartering income?

(v) is it possible to compute a price for the loan that AE Co 2 would reasonably be able to pay (taking into account its potential future cashflows) and that would properly remunerate AE Co 1 for the risk it is taking on? The circumstances suggest that any standalone credit rating of AE Co 2 would be below

investment grade and that AE Co 2 would present a significant credit risk. If not, is it possible to compute a price if part of the advance is treated as equity?

The guidance in Section B.9.2.1 is generally applicable to the considerations outlined above, and in B.9.2.1.3 is particularly relevant to this example.

B.9.2.2. Considering the creditworthiness of associated enterprises

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

B.9.2.2.2. Credit risk may be measured by assigning a rating (i.e. credit rating) to the tested party. These ratings may be derived from independent commercial credit rating agencies. The rating expresses the probability of default. Some MNEs have developed in-house commercial tools that can be used for credit rating purposes. Official credit ratings provided by independent credit rating agencies generally consider qualitative and quantitative factors. Whereas credit rating methodology used by in-house commercial tools may mostly consider quantitative factors and not necessarily qualitative factors such as industry forecast, MNE Group Strategy and risk profile resulting from the MNEs management style. Determining a credit rating is not necessarily an exact science and can be particularly difficult for certain types of issuers such as start-ups, special purpose vehicles, or indeed for individual members of an MNE group. The process relies on both quantitative and qualitative factors, and there is likely to be some variance in creditworthiness between issuers with the same credit rating. In the case of a credit rating determination for a member of an MNE Group, the financial metrics used in the process may be influenced by related party transactions. Credit rating agencies tend to summarize credit ratings as illustrated by the following table. It should be considered that, however useful, credit ratings are only an indication of an entity's probability of default. Although credit ratings are important and useful, they may not always be perfect. For example, in the 2009 financial crisis, some entities with high credit ratings nevertheless ended up going bankrupt. Furthermore, in some developing countries the government may have official prescribed interest rates in place and no use is made of international commercial credit rating approaches.⁷

⁷ Reference can be made to credit rating rules that are applicable in Mexico and China.

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Table 1.

Moody's	S&P	Fitch	Interpretations ⁸
Investment Grade Ratings			
Aaa	AAA	AAA	Highest quality; extremely strong, highly unlikely to be affected by foreseeable events.
Aa1	AA+	AA+	Very high quality; capacity for repayment is not significantly vulnerable to foreseeable events.
Aa2	AA	AA	
Aa3	AA-	AA-	
A1	A+	A+	Strong payment capacity; more likely to be affected by changes in economic circumstances.
A2	A	A	
A3	A-	A-	
Baa1	BBB+	BBB+	Adequate payment capacity; a negative change in environment may affect capacity for repayment.
Baa2	BBB	BBB	
Baa3	BBB-	BBB-	
Below Investment Grade Ratings			
Ba1	BB+	BB+	Considered speculative with possibility of developing credit risks.
Ba2	BB	BB	
Ba3	BB-	BB-	
B1	B+	B+	Considered very speculative with significant credit risk.
B2	B	B	
B3	B-	B-	
Caa1	CCC+	CCC	Considered highly speculative with substantial credit risk.
Caa2	CCC	CCC	
Caa3	CCC-	CCC-	
Ca	CC	CC	May be in default or wildly speculative.
Ca	C	C	In bankruptcy or default.
C	D	DDD	

⁸ 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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B.9.2.2.3. In general, when applying the arm's length principle, the starting point is that the related parties involved in the financial transaction should be treated as if they were entities independent of each other, but otherwise in the same circumstances. However, "the same circumstances" must include any incidental benefits and group synergies that derive from the fact that the related entities belong to an MNE group. This would include the impact of any implicit support (sometimes also referred to as 'passive association', 'parent support', or 'group support'). To the extent that a borrower that is a member of an MNE group benefits from an improved credit rating solely on the basis of implicit support, no payment is required to be made for this benefit.

B.9.2.2.4. However, credit ratings from independent professional rating agencies such as Standards & Poor's, Moody's or Fitch, are typically only available for the parent company of the group. Where no such independent credit rating is available for the borrower of the funds, consideration will therefore need to be given as to how to evaluate the credit risk of that borrower. The following approaches may be considered:⁹

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

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

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

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

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

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

⁹ There are additional approaches used in practice that may lead to an approximate credit rating for the borrower such as looking at third party loans of the borrower and based on those third-party loans re-engineering the credit rating of the borrower.

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

The following table is an example of the possible effect of such levels of strategic importance on the credit rating of a borrower:¹⁰

Table 2.

Strategic importance of the specific entity for the group	Brief explanation of the strategic importance	Potential long-term credit rating of the specific entity
<i>“Top down” approaches</i>		
<i>Core</i>	Integral to the group’s current identity and future strategy. The rest of the group is likely to support these entities under any foreseeable circumstance.	Generally, at group level
<i>Highly strategic</i>	Almost integral to the group’s current identity and future strategy. The rest of the group is likely to support these entities under almost all foreseeable circumstances.	Generally, one notch below group level
<i>“Bottom-up” approaches</i>		
<i>Strategically important</i>	Less integral to the group than highly strategic entities. The rest of the group is likely to provide additional liquidity, capital or risk transfer in most foreseeable circumstances. However, some factors raise doubts about the extent of group support.	Generally, three notches above stand-alone rating
<i>Moderately strategic</i>	Not important enough to warrant additional liquidity, capital or risk transfer support from the rest of the group in some foreseeable circumstances. Nevertheless, there is potential for some support from the group.	Generally, one notch above stand-alone rating

¹⁰ Table 2 is based on S&P’s General Criteria: Group Rating Methodology (1 July. 2019), available at <https://www.maalot.co.il/Publications/GMT20190702155208.PDF>. Table 2 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.

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<i>Nonstrategic</i>	No strategic importance to the group. These entities could be sold in the near to medium term.	Generally, stand-alone rating
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It should be noted that implicit support does not equal an explicit guarantee and is generally unenforceable by a creditor of the borrower. Please also see section B.9.4. on financial guarantees.

B.9.2.2.8. It is also important to note that although implicit support is typically associated with a higher credit rating for the borrower, it might also be the case that the borrower’s credit rating is negatively influenced by the MNE group’s credit risk (i.e. as a result of negative synergies). In addition to the credit rating of the debtor, for accurate delineation purposes the credit rating of the debt instrument that is considered is also relevant. See B.9.3.2.¹¹

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

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

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

Example 3: The relevance of implicit support on a company’s credit rating

A group entity’s strategic importance might be impacted by facts such as whether it operates under the same commercial group identity as other MNE group members or whether it is engaged in the exact same business as other group members of the group. For example, assume an MNE group named ABC

¹¹ For additional information on how to measure credit risk and how to consider credit risk components, reference is made to the publication “Transfer Pricing Aspects of Intra-Group Financing” by Raffaele Petruzzi.

is widely known and respected for its safe handling and transportation of cash and valuables, an activity it performs globally. The MNE group is also financially strong. Assume ABC has a subsidiary operating under the same global group identity (DEF) that is associated with the safe handling of cash and valuables in Country A. Due to Central Bank policies reducing the use of cash in Country A, a high level of organized crime in Country A and the rise of competitor business in Country A, the subsidiary's expected future profitability is low or even negative. DEF has difficulty servicing a third-party loan and defaults on the loan. This default, if unresolved, may impact the credit rating of the ABC group negatively, because it may have been expected by third party lenders that the ABC group parent company would have rescued its subsidiary that operates in the same business under the same group identity for fear of damaging the group's reputation and core business. On the other hand, if the subsidiary was operating under a different group identity, XYZ, and engaged solely in the servicing of cash sorting machines, a minor and insignificant commercial activity that the ABC group does not perform in any other markets, and not engaged in the core business of picking up cash and valuables for safe transportation, the impact of a default might be less significant for the reputation or core business of the ABC group. In this case, the relevance and impact of implicit support is likely to be more significant in the case of DEF and much more limited in the case of XYZ.

B.9.2.3. Considering the risks embedded into the financial instrument

B.9.2.3.1. The credit rating of the debtor tends to be the first creditworthiness analysis to be conducted when analysing intercompany financial transactions. To accurately delineate the actual financial transaction and to be able to seek reliable comparables to test the arm's length nature of the intercompany financial transaction, the specific features of the financial instrument also play a role. If one considers that associated enterprise ACo makes available a loan to associated enterprise BCo, yet BCo already has obtained three different loans prior to this latest intercompany loan (regardless from what sources the previous three loans are), and the loan BCo gets from ACo is subordinated to the other three loans, then the "status" of the loan between ACo and BCo in essence is lower than that of the other three loans. If lender ACo will only be entitled to claim repayment from BCo in case of BCo's bankruptcy after the latter has repaid the other three different loans, it holds a subordinated loan instrument with a higher risk. In the case of bonds (that may be used as a comparable for loans) this risk "status" is generally expressed as the "issuance" credit rating. For loans this could be referenced as "financial instrument-specific credit rating." Thus, the credit rating of a specific financial instrument is also linked to the specific features of that particular financial instrument and not only to the risk profile of the borrower.

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

For example, let's assume that the credit rating of BCo is BBB, and the financial instrument provided by ACo to BCo is subordinated. And let's assume that in line with the methodology provided by credit

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

B.9.2.4. Potential Transfer Pricing Methods

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

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

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

B.9.2.5. The use of Simplification Measures and Safe Harbours

B.9.2.5.1. To simplify the determination of the arm's length price for intra-group financial transactions, a few countries have been introducing safe harbours, most of which concern interest rates. More specifically, some countries annually issue official interest rates that, if applied to the intra-group loans, extinguish the obligation for the taxpayer to prove the arm's length nature of the compensation related to those transactions, while providing some assurance that the intercompany rate will not pose a risk of base erosion.¹²

¹² As an example, Singapore provides a safe-harbour rule for intercompany interest rates which is rebuttable by taxpayers who want to substantiate the interest rate with a proper economic analysis and TP documentation. In general, the indicative

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B.9.2.5.2. Access to the credit rating of individual associated enterprises and the determination of the impact/effect of implicit support on intra group financing transactions are not easily available and are based on judgements/determinations that are very hard to be verified by tax administrations. Therefore, another consideration for simplification could be to use the MNE Group credit rating as basis when reviewing the arm's length nature of the financial transaction between the respective associated enterprises, if taxpayers do not corroborate the credit rating used. This approach has the added benefits of providing certainty and reduction in administrative burden to both tax administrations and taxpayers. See B.9.2.2.9. supra. The same approach could be considered if taxpayers do not sufficiently corroborate the interest rate used on intra group loans (by prescribing a basis point margin on top of a base rate).

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

B.9.3. The application of the arm's length principle to intra-group loans

B.9.3.1. Different types of intra-group loans and relevant characteristics to consider

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

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

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

- Term loan: a loan with a specified schedule for the payment of interest and the principal amount¹³, and a maturity ranging from 1 to 10+ years. Such loans are often used to fund medium- and long-term assets such as plant and equipment as well as average inventory levels. A term loan may be secured or unsecured, carry a fixed rate or a floating rate, and contain general or specific performance covenants.
- Revolving loan or revolving credit facility: a secured or unsecured credit line with a maturity ranging from six months to five plus years that a borrower can draw down and repay multiple times. A typical facility requires the borrower to pay the bank an annual commitment fee on the entire line in order to keep it available for future use; those without a fee are typically not committed and may be withdrawn by the bank at will. In some instances, banks require borrowers to repay the facility in full before allowing further draw-downs or renewals (a process known as a clean-up call).

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

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

B.9.3.2. Determining the arm's length nature of intra-group loans

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

- The contractual terms of the tested loan (e.g., the type of loan, tenure – i.e., time to maturity – of the loan, the obligation to pay (by way of a bullet payment at the end of the term or by way of fixed amounts throughout the term of the loan) and type of interest rate (e.g. contingent on profits, variable or fixed)), currency used, embedded options such as the right to convert the loan into equity or right to extend the term of the loan or prematurely terminate and repay the

¹³ 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.

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loan, seniority of the loan, subordination of the creditor as compared to other creditors that are granted superior rights, collateral, security and guarantees provided to the creditor that the nominal amount of the loan will be repaid, repayment schedule (e.g. fixed amounts, or payments contingent on having net profit available). In some cases, certain relevant characteristics may not be included in the contractual agreement, and it may be necessary to refer to other documents and to the conduct of the parties to accurately delineate the terms of the loan.

- The functions performed, assets used, and risks assumed by both the borrower and the lender, considering the purpose of the loan and any interaction with other intra-group transactions. This functional analysis considers the perspectives of both borrower and lender and involves e.g. an assessment of the debt capacity and credit risk of the borrower including the risks stemming from the financial instrument-specific credit rating. The conduct of the parties should also be examined. Where such conduct does not align with the contractual terms, the former may need to be prioritized.
- The economic circumstances of both the borrower and the lender and of the industries and market in which they operate, including circumstances which have a bearing on the type of funding available, but also the ability of the borrower to obtain loan financing/funding through other means from other (third) parties and the purpose of the funding.
- The business strategies pursued by the borrower and lender, including financing policies and debt targets.

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

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

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

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

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B.9.3.2.5. When using an external CUP method, the information deriving from third party (syndicated) loans and bonds and other information contained in publicly available databases may be beneficial. Comparable uncontrolled interest rates for borrowers with a range of credit ratings can be accessed through databases made available by professional commercial data vendors.¹⁴ 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.9.3.2.6. When applying the CUP method, it will be essential to verify that all the economically relevant characteristics (or comparability factors) illustrated before that have a material effect on the interest rate are taken into account; hence, the resulting interest rate might also need to be adapted by means of comparability adjustments in order to reflect such factors, as long as such adjustment can be made reliably.

B.9.3.2.7. Apart from the CUP method, as mentioned before, a cost-based method could possibly be applied in some cases (e.g., in cases of on-lending whereby an entity of a group obtains financing from an unrelated entity and provides the resources obtained to a related entity, i.e. “pass-through” scenarios). In essence the intercompany loan is priced based on the cost of funds incurred by the lender who is raising the funds to lend, together with the expenses of arranging the loan and the relevant costs incurred in servicing the loan, a risk premium to reflect the various economic factors inherent in the proposed loan, plus a profit margin.¹⁵ While applying this method to price the intercompany loan, the lender’s cost of funds relative to other lenders in the market may also need to be considered. A lender in a competitive market would probably seek to price at the lowest possible rate to win business. A borrower, likewise, would probably seek to borrow at the lowest rate available to it in the market. As with other methods, this method also requires consideration of options realistically available to the borrower, who would enter into this transaction only if there is no better alternative available.

B.9.3.2.8. Some countries apply a simplification rule for determining the interest rate for loans that resembles the “sixth method” that is discussed in Chapter B.3.4.2. (in this regard, the comparable transaction interest rate could be the interest rate for international public bonds such as the US bonds, or the London InterBank Offered Rate (LIBOR) or even the interest rate of bonds issued by the country where the company making the loan is resident or where the loan is negotiated based on the country’s currency). These rates may work as proxies for interest rates of financial transactions between unrelated parties that may or may not be subject to appropriate adjustments for specific situations. The outcome of this approach provides a similar advantage as does the sixth method rule for commodities, that’s to say it eliminates the need for a comparable transaction.¹⁶

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

¹⁴ Reference can be made for example to Bloomberg, Loan Connector, Reuters and S&P.

¹⁵ See also Paragraphs 10.97-10.98 of the OECD *Transfer Pricing Guidance on Financial Transactions* (2020).

¹⁶ Brazil currently applies this methodology – see Subpart D.1.8.4 of the 2017 UN Manual, p. 542-543.

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

Example 4: accurate delineation of the actual transaction (loan maturity)

Borrowing Company, BCo, pays loan interest to Lending Company, LCo, in its 2019 financial period. BCo and LCo are associated enterprises. The loan agreement shows that the loan was made in January 2017 at a fixed interest rate of X% and specifies that the term of the loan is for a twelve-month period, at the end of which the principal is repayable. At the time the loan agreement is signed, based on BCo projected cash flows, it seems very unlikely that BCo will be able to repay the loan after twelve-months. On further examination of the facts, it is found that BCo has expanded its business since January 2017, using the loan from LCo to purchase fixed assets. Since the principal was used to purchase fixed assets, a repayment of the principal could not be made under the terms of the loan. In addition, no repayment has been made under the terms of the loan, and BCo has continued to pay interest at X% on the loan in its 2018 and 2019 financial periods. BCo and LCo exchanged letters in January 2018 to confirm the extension of the loan for a further period of twelve months and repeated the exchange in January 2019. The accurate delineation of the actual transaction determines that the loan is not in fact treated as a short-term loan of twelve months and should not be priced as a short-term loan but one with longer maturity. For pricing purposes, the maturity is at least three years, since the loan is by 2019 in its third year, or such longer period as might be evidenced by the purpose of the loan (in this case funding the purchase of fixed assets).

Example 5: accurate delineation of the actual transaction (currency of the loan)

Borrowing Company, BCo, pays loan interest to Lending Company, LCo. BCo and LCo are associated enterprises. The loan agreement specifies that the advance is denominated in currency X. On further examination of the facts, it is found that the advance was made in currency Y, and regular interest payments have been made in currency Y computed on the outstanding balance expressed in currency Y.

The accurate delineation of the actual transaction determines that the loan is treated as having been made in currency Y. For pricing purposes, the loan should be considered as a currency Y denominated loan when determining the appropriate interest rate.¹⁷

¹⁷ It is worth noting that, if the interest rate is floating, this will be made up of two parts, i.e. a fixed margin and a floating base rate. The currency change will have an impact on the original margin setting as well as on the base rate.

Example 6: accurate delineation of the actual transaction (loan security)

Borrowing Company, BCo, pays loan interest to Lending Company, LCo, in its 2019 financial period. BCo and LCo are associated enterprises. The loan agreement shows that a loan of \$5m was advanced on 3 March 2019 at a fixed interest rate of 5% and specifies that the term of the loan is for ten years, at the end of which the principal is repayable. The loan agreement makes no reference to any security pledged by BCo to support the loan.

On further examination of the facts it is found that BCo is part of the MNE Group, ExtraSpace, that rents storage to customers. BCo owns storage premises, and on 3 March 2019 completed the purchase of two further premises for \$6m. At the same time, BCo repaid the outstanding principal of \$1m on a loan from a third-party bank. After repayment of the bank loan, BCo does not have any remaining third-party borrowings, and none of its assets are pledged in security. LCo has several bank loans, all of which (apart from short-term facilities) are secured on its storage premises. Similarly, most other term loans of the MNE group from banks are secured on the storage premises assets of the borrower entity. The previous bank loan that BCo repaid in March 2019 was secured on its assets held before that date.

The accurate delineation of the transaction determines that BCo took out the intra-group loan at the time it acquired new assets. Those assets are capable of providing security for the loan and are available to provide such security. The MNE Group, ExtraSpace, customarily uses its assets as security in arrangements with third-party banks, and BCo had also previously provided assets as security. For pricing purposes, the loan should be treated as supported by the security of assets owned by BCo in the absence of evidence that the commercial advantage of lower interest costs would be offset by potential commercial disadvantages in BCo pledging its assets in comparable uncontrolled arrangements.

Example 7: the internal CUP method for intra-group loans¹⁸

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.

BCo also receives financial resources from a third-party lender, with the same conditions as the ones agreed with ACo.¹⁹ If the two loans are comparable (i.e. considering all the economically relevant characteristics), 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 third-party loan is such that the credit rating of BCo would be relevantly reduced, the interest rate of this third-party loan may not present a proper internal CUP for the intra-group loan.

¹⁸ Examples 7, 8 and 9 start from the assumption that, based on the accurate delineation of the actual transaction, the intra-group contracts are in line with the conducts of the parties. Therefore, the examples focus on the question of pricing the intra-group arrangement.

¹⁹ One of the relevant assumptions is that subordinations of the two loans received by BCo are *pari passu*. Therefore, both loans rank equally and are not subordinated to the other.

Example 8: the external CUP method for intra-group loans

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.

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 for intra-group loans

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.

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

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 bonds²⁰ in order to identify the arm's length intra-group interest rate.²¹

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.

²⁰ In practice, the use of Yields to Maturities might be more appropriate.

²¹ It should be considered that, in some situations, an illiquidity premium might be considered in order to account for the different liquidity between loans and bonds.

Example 10: Interplay between intra-group loans and other intra-group transactions

Company A, a 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, not taking into account any working capital adjustments.

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. Something seemed amiss.

The tax inspector decided that further information about the loan was needed and determined the sole purpose of the intra-group funding was to finance the cost of extending more favourable credit terms to its customers. The tax inspector further 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. In effect, Company A provided an incentive to its customers by taking on some of their working capital funding costs. This had the effect of significantly increasing Company A's working capital (in particular its accounts receivables). Unlike other kinds of sales incentives, however, the costs incurred by Company A (as associated enterprise interest expenses) are not included as part of the operating costs, and therefore, not considered as part of the operating profits used in calculating the operating profit margin.

The tax inspector concluded that there was no basis to question either the substance (e.g., through non-recognition) or 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 appropriately took into account all of the economically significant circumstances. In particular,

working capital adjustments seemed appropriate to improve comparability in accordance with the guidance at B.2.3.5.7. They were applied by the tax inspector to adjust for the (higher) working capital of Company A compared to the comparable companies, effectively increasing the arm's length operating profits to account for the more generous credit terms that the loan (and the associated interest payments) allowed.

Example 11: Interplay between intra-group loans and other intra-group transactions

The facts are the same as Example 15A, except that the tax inspector is not able to reliably apply the working capital adjustments, because the spikes in Company A's working capital due to seasonal peaks for sales occur in Q2 and Q3, and so are not reflected in the year-end balance sheets. Accordingly, the application of the TNMM could be reliably improved by comparing profits before tax rather than operating profits, since both Company A and the comparables are assumed to maximise profit through their collective commercial decisions about incentives, credit terms and funding costs, not all of which are reflected in operating profits.

It is important to note that the reliability of this approach may be reduced to the extent that the loan is not solely used to finance working capital. However, determining the purpose of the loan can help to improve reliability of comparisons under the TNMM. For example, a loan which is used to acquire fixed assets may indicate additional functions that affect the reliability of the benchmarking. A loan for such a purpose may also indicate changes in asset intensity. Diagnostic ratios may be applied to determine comparables with similar asset intensity to improve reliability in accordance with the guidance at B.2.3.4.40.

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

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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 intent²² and keep-well agreements²³, but these generally do not transfer risk and generally are not considered as financial guarantees that require an arm's length payment.

B.9.4.1.4. A particular issue also in the field of intercompany financial guarantees in MNE context is the concept of 'implicit support': a lender may be willing to accept conditions for a loan granted to a borrower under the assumption that the parent company of the borrower will step in and meet the obligations of the borrower, in case the latter cannot perform under the loan, without having received any legally binding confirmation to that extent from the parent company. In that case, the lender is merely assuming that there is a possibility that the parent company will assume the obligations of its associated enterprise/the borrower. Implicit support involves no explicit assumption of risk by the parent company deemed to be the guarantor and no explicit right for the lender to ask the parent company to assume the obligations of the borrower in case the latter defaults. See also Chapter B.9.2.2.

B.9.4.1.5. The first issue in considering a financial guarantee is the extent to which there is 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

²² 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.

²³ 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.

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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.

B.9.4.2. Determining the arm's length nature of intra-group financial guarantees

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

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

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

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

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

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

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

- The guaranteed entity is perceived as having a better creditworthiness only because of its group affiliation (so-called 'implicit support').

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- 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, an accurate delineation of the transaction might lead to the conclusion that the guarantee provided by the parent company is a function performed in its own interest and that the parent company, by providing the guarantee, essentially and substantively is the borrower.²⁴
- 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).

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

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

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

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

²⁴ E.g., the accurate delineation of the transaction could suggest that the transaction is not a guarantee arrangement at all, but that the purported guarantor is in fact the direct borrower.

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

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

Example 12: Financial guarantee and implicit support

ACo located in Country A is the holding company of an MNE group. ACo needs financial resources for the group's activities from external investors. For these purposes, ACo establishes a Special Purpose Vehicle (without control over risks), BCo, in Country B, which exclusive function is the issuance of bonds, securities and other financial instruments into the market on behalf of the group. The group follows a common international standard procedure consisting in using BCo as a mere intermediary financial entity to obtain funds in the capital market. This standard procedure as a matter of process has certain -standard- legal and contractual requirements including a formal guarantee by ACo of the bonds or securities issued.

The market is made fully aware through the prospectus and other relevant materials that BCo is issuing bonds or securities on behalf of the group and, therefore, regards BCo as having the same

creditworthiness as ACo. In this case, the effect of implicit support on BCo is such that the addition of explicit guarantee of the bonds or securities by ACo provides no benefits to BCo and, as such, no guarantee fee should be payable.

It is appropriate to remunerate BCo for its role in issuing the bonds or securities on behalf of the group with a service fee.

Example 13: the internal CUP method for intra-group financial guarantees²⁵

ACo, located in Country X, is an associated enterprise 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 a different loan (having the same characteristics of the third-party loan guaranteed by ACo) 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), 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 14: the external CUP method for intra-group financial guarantees

ACo, located in Country X, is an associated enterprise 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).²⁶

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.

Example 15: The yield approach for intra-group financial guarantees²⁷

ACo, located in Country X, is an associated enterprise of BCo, located in Country Y. BCo has requested a 5-years loan from a third-party lender. ACo has provided an intra-group financial guarantee for this loan. The third-party lender has provided the loan to BCo at an interest rate of 2%.

²⁵ Examples 13 and 14 start from the assumption that, based on the accurate delineation of the actual transaction, the intra-group contracts are in line with the conducts of the parties. Therefore, the examples focus on the question of pricing the intra-group arrangement.”

²⁶ However, availability of these information might be scarce.

²⁷ Examples 15 and 16 start from the assumption that, based on the accurate delineation of the actual transaction, the intra-group contracts are in line with the conducts of the parties. Therefore, the examples focus on the question of pricing the intra-group arrangement.

ACo's credit rating is A, while BCo's credit rating (after considering the effect of implicit support) is BBB.

Based on information available from public sources, a third-party comparable loan (i.e. considering all the economically relevant characteristics, except for the intra-group financial guarantee) would have an interest rate of 3.25%.

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 1.25% (i.e. 3.25% - 2%). Therefore, the arm's length maximum intra-group guarantee fee might be 1.25%. However, this guarantee fee might be reduced by considering how the advantage deriving from the guarantee should be divided between ACo and BCo.²⁸ The results of applying the cost approach (see example 6B) can be used to determine this split between ACo and BCo.

Example 16: the cost approach for intra-group financial guarantees

Facts are the same as in Example 15.

BCo's expected 5-years probability of default rate²⁹ is 1.44% and its expected recovery rate³⁰ (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 0.86% (calculated as follows: $1.44\% \times (1 - 40\%)$).

Therefore, the arm's length minimum intra-group guarantee fee might be 0.86%. However, this guarantee fee might be increased by considering how the advantage deriving from the guarantee should be divided between ACo and BCo.³¹ The results of applying the yield approach (see example 6A) can be used to determine this split between ACo and BCo.

It is worth noting that, in order to determine the arm's length range of intra-group guarantee fees, it is not always necessary to apply both cost approach and yield approach.

²⁸ As a pragmatic approach, this advantage could be divided in half between ACo and BCo.

²⁹ 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

³⁰ Recovery rate is the extent to which principal and accrued interest on defaulted debt can be recovered, expressed as a percentage of face value.

³¹ As a pragmatic approach, this advantage could be divided in half between ACo and BCo

[NOTE: Part C.1 was first considered at the 19th Session, and was approved at the 20th Session. Paras C.1.2.4.5-6 were agreed to be added at that Session. Part C.6 was first considered at the 20th Session and is put for final approval at the 21st Session. All but Part C.6 is therefore shaded]

PART C: TRANSFER PRICING LEGISLATION DESIGN AND PRACTICAL IMPLEMENTATION OF A TRANSFER PRICING REGIME

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

C.1.1. Introduction

C.1.1.1. Background

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

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

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

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

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

C.1.1.1.4. Many countries have implemented advance pricing agreements (APAs) in their legal and/or administrative procedures as a bilateral resolution mechanism to avoid double taxation. Other countries have introduced an arbitration procedure to give certainty that a dispute will be resolved. The advantages and disadvantages of these solutions are dealt with in Chapter C.6.; however, the application of these solutions will be influenced by the legal environment of each country, and thus will take place in a variety of ways.

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

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

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

C.1.1.2.3. This chapter also addresses the practical implementation of transfer pricing rules in a particular jurisdiction. As such, guidance is provided on:

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

C.1.1.2.4. The rest of the chapters in Part C deal in depth with specific areas of implementation and administration. Chapter C.2. sets out important considerations in establishing transfer pricing capability in developing countries. Chapter C.3. covers the documentation requirements central to a transfer pricing regime, transparency issues and exchange of information, in an increasingly complex business environment. Chapter C.4. provides a useful framework for risk assessment for transfer pricing purposes, and C.5. discusses transfer pricing audits and provides guidance on approaches to managing audit programmes. Chapter C.6. provides insights into approaches and techniques for dispute resolution, including how to access dispute resolution systems. Part C thus aims to provide a

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

set of approaches by which a tax administration in a developing country can introduce and sustain a transfer pricing regime that meets international standards.

C.1.1.3. Domestic Transfer Pricing Legislation: Structural Overview

C.1.1.3.1. As already noted in Chapter B.1., “transfer pricing” is essentially a neutral concept. However, the term is often used, incorrectly and in a pejorative sense, to mean the artificial shifting of taxable income from one company within an MNE, to another company of the same group, in another jurisdiction, through incorrect transfer prices. The aim of such practices is to reduce the overall tax burden of the group. In such instances, the issue is the fact that the transfer price is not at arm’s length. In this Manual “transfer mis-pricing” is used to denote instances when the transfer price set is not at arm’s length. See Chapter B.1., paragraph B.1.1.7.

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

C.1.1.3.3. Another approach to transfer pricing income allocation is referred to as global formulary apportionment (GFA). However, such a system cannot operate at a global level, in a way that fully avoids double taxation, without prior global agreement on a suitable uniform formula, which has not yet been achieved. This Manual addresses transfer pricing rules based on the arm’s length principle. Virtually all developing countries accept the arm’s length principle as part of their bilateral tax treaties and have adopted the arm’s length principle as the basis for their domestic transfer pricing law. This Manual does not deal with the advantages and disadvantages, in the longer term, of other possible alternative ways of dealing with transfer pricing, including GFA.

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

C.1.1.4.1. Some countries have formally recognized the guidance provided in the Manual in their domestic law. For some of those countries, the guidance in the Manual provides useful reference for the application of the domestic legislation, unless there is inconsistency between the guidance in the Manual and that in domestic law.

C.1.1.4.2. An example of a country’s legislation that recognizes the guidance in the Manual is Tanzania’s transfer pricing regulations 2018 which provides that the transfer pricing regulations are to be interpreted in a manner consistent with the arm’s length principle in Article 9 of the UN Model Convention and the Manual. The Regulations also provide that they are to be interpreted in a manner consistent with Article 9 of the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines.

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C.1.1.4.3. Another example is Zimbabwe which enacted transfer pricing legislation in 2016. These provisions formally recognize the Manual and the OECD Transfer Pricing Guidelines as guidance documents.

C.1.1.4.4. Two different broad approaches may be seen in domestic legislation relating to transfer pricing. Both of these approaches seek to implement an arm's length approach in relation to controlled transactions:

C.1.1.4.5. The first possible legislative approach simply authorizes the tax administration to distribute, apportion or allocate gross income, deductions, credits etc. when the tax administration determines that such distribution, apportionment or allocation is necessary in order to prevent tax avoidance or clearly reflect the income of any organizations, trades or businesses.³ Under this system there is no reference to the taxpayer's compliance obligation in determining the arm's length price, while the arm's length principle may be stipulated in either the general primary legislation or within regulations or secondary legislation supporting the primary legislation.

C.1.1.4.6. The second legislative approach stipulates that, based on the self-assessment system, any foreign affiliated transaction shall be priced for tax purposes as if it had been conducted at arm's length.⁴ In other words, a non-arm's length transaction is reconstructed as an arm's length transaction for the purposes of calculating taxable income and taxing such income. This legislative approach effectively requires that taxpayers to conduct their initial tax accounting based on the arm's length principle.

C.1.1.4.7. A country's choice between these two approaches will depend on the basic principles of domestic tax law in that country. This will include issues such as the form of anti-avoidance legislation, time limits for application of the legislation, and where to place the burden of proof. However, the choice of styles of domestic legislation has made no substantial difference in the legal procedure of implementing the arm's length principle. The manner in which arm's length methodologies are stipulated in each country's legislation differs to some extent, as described below.

C.1.1.4.8. Depending on the legal system of the country concerned, tax laws may set out in great detail issues such as the definition of related parties, transfer pricing methodologies, documentation, penalties and the procedures for APAs. Other countries might opt only to identify the basic structure of tax base allocation among the related parties under the arm's length principle. In the latter case, detailed practical guidance will normally be available in subordinate legal materials, such as regulations, administrative rules and public notices. Even if such matters are defined in great detail in the primary tax law, there is a need to provide clear operational guidance. Tax administrations should consider the level of guidance available in their countries, and determine if further detail is needed.

C.1.1.4.9. There remains substantial risk of double taxation even when two countries follow the same general arm's length principle approach. For example, double taxation may occur where specific guidance on the implementation of the arm's length principle is different from one country to another, and countries do not bridge this gap with any specific understanding or interpretative guidance. The following paragraphs demonstrate potential significant differences in domestic law which may result in major differences in how countries interpret or apply the arm's length principle.

C.1.1.5. Associated Enterprises

C.1.1.5.1. The definition of which persons (companies, trusts, individuals and other entities) and therefore transactions are covered by transfer pricing legislation is a key issue since the arm's length

³ E.g. US Internal Revenue Code §482.

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

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principle applies to transactions between related parties. Article 9 of both the UN and OECD Models considers enterprises to be “associated” (i.e. “related parties”) if one of the enterprises meets the conditions of Article 9, Subparagraph 1(a) or 1(b) with respect to the other enterprise. These subparagraphs cover so-called parent-subsidiary relationships and brother-sister relationships.

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

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

C.1.1.5.4. Differing threshold criteria can result in disputes in certain circumstances. For example, if in Country A, the domestic law stipulates that a shareholding of 50 percent or more is the threshold to qualify as an “associated enterprise”, transactions between an entity owned 50/50 by two otherwise independent parties and one of its shareholders would be covered by the transfer pricing rules. However, if in Country B, the domestic law provided for a shareholding threshold of above 50%, the same transaction would not, *prima facie*, be subject to the transfer pricing rules in that jurisdiction.⁵

C.1.1.5.5. In South Africa, transfer pricing rules are applied to cross-border transactions between related persons, referred to under domestic law as “connected persons”. A connected person is defined in relation to natural persons, trusts, members of partnerships and companies. Companies could be connected persons based on prescribed criteria including if one of the companies holds at least 20 per cent of the equity shares or can exercise at least 20 per cent of the voting rights in the other company. As an additional example, in Brazil, foreign companies and companies domiciled in Brazil are considered as associated companies when at least ten percent of the share capital in one [or both] of the companies is owned by the same individual or legal entity. The transfer pricing legislation also applies concepts of the Company Law to other situations to characterize two companies as associated or controlled companies. In fact, Brazilian transfer pricing legislation is very broad regarding the concept of “related persons”, e.g. it also considers the kinship of the individual resident in the foreign country performing commercial relations with companies in Brazil that are controlled or managed by his or her relatives (depending on the kinship grade); and all transactions performed with listed jurisdictions (low-tax and non-cooperative jurisdictions) are deemed related persons.

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

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

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

C.1.1.6.1. Transfer pricing generally covers all cross-border transactions involving a country, regardless of whether participants are residents or non-residents. Thus, transactions conducted between a permanent establishment (PE) of a foreign company located in a jurisdiction and its affiliate company located in another jurisdiction are also subject to transfer pricing rules under the domestic law of that jurisdiction. In contrast, a transaction between a domestic PE of a foreign company and its affiliated company located domestically may not be subject to the transfer pricing rules in certain jurisdictions, such as Japan, because there is no substantial risk of income shifting beyond their borders, see paragraph [C.1.1.3] for further information.

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

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

C.1.1.6.4. Ease of administration is another important issue in the design of legal frameworks. Documentation requirements supported by penalties for non-compliance are the main instruments used by tax authorities for collection of sufficient information to test whether or not taxpayers have established an arm's length result. Preparing transfer pricing documentation can result into significant compliance cost for MNEs, especially if there are differences in countries' requirements. There is value in seeking to align documentation requirements with those of other countries, unless there are good reasons in terms of reducing compliance and collection costs, or specific features of local legislation, that require differences. Action 13 of the OECD/G20 BEPS Project specifically focused on transfer pricing documentation and country-by-country reporting, and guidance has been published on the implementation of relevant measures.⁶ Regarding transfer pricing documentation and country-by-country reporting guidance, refer to Chapter C.3.

C.1.1.6.5. Some differences in the coverage of transactions or in the legal form (statutes with penalty provisions or administrative guidance on self-assessment) will remain. It is therefore appropriate to

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

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continuously evaluate documentation and penalty legislation for effectiveness and proportionality. The experience of countries that have introduced transfer pricing rules may be helpful to developing countries just starting to introduce transfer pricing legislation.

C.1.1.7. Burden of Proof

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

C.1.1.7.2. The burden of proof operates in litigation. However, it is important to be able to consider which party has the burden of proof during a tax audit exercise or when transfer pricing assessments are made because the case may ultimately end up in court.

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

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

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

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

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

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C.1.1.7.7. Tax administrations and taxpayers may encounter several challenges in meeting their respective burdens of proof. As a practical matter, associated enterprises normally establish the conditions of a transaction at the time the transaction is undertaken. In auditing these transactions, the tax administration may have to engage in a verification process perhaps some years after the transactions have taken place. Moreover, at some point the associated enterprises may be required to prove that these transactions are consistent with the arm's length principle. As a part of the due diligence process, the arm's length principle may result in a compliance burden for the taxpayer and an administrative burden for the tax administration in evaluating significant numbers and types of the transactions. The tax administration would review any supporting documentation prepared by the taxpayer to show that its transactions are consistent with the arm's length principle. The tax administration may also need to gather information on the comparable uncontrolled transactions and the market conditions at the time the transactions took place, for numerous and varied transactions. Such an exercise usually becomes more difficult with the passage of time. In such instance, both taxpayers and tax administrations often have difficulty in obtaining adequate information to apply the arm's length principle.

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

Time Limitations

C.1.1.7.9. Another important point that should be addressed in transfer pricing domestic legislation is the "statute of limitations" issue—the time allowed in domestic law for the tax administration to complete transfer pricing audits and make necessary assessments. Since a transfer pricing audit can place heavy burdens on the taxpayers and tax authorities, the normal "statute of limitations" period for taking action is often extended compared with general domestic taxation rules. However, too long a period during which adjustment is possible leaves taxpayers in some cases with potentially very large financial risks. Differences in country practices in relation to time limitation should not lead to double taxation. Countries should keep this issue of balance between the interests of the revenue and of taxpayers in mind when setting an extended period during which adjustments can be made.

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

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

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

C.1.1.8.3. The effectiveness of presumptive taxation depends on the approach adopted by the country concerned i.e. the choice between self-assessment and being assessed by the authorities/tax administration. On the one hand, under a self-assessment system, where the tax authorities always have the burden of proof whenever they propose an adjustment, presumptive taxation may appear more attractive when there is not enough relevant information to compute the arm's length price. On the other hand, in an anti-avoidance focused system where taxpayers have an initial burden of proof on the authorities' adjustments, a penalty system may play a more effective role than presumptive taxation to avoid the generalized mispricing of related party transactions.

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

C.1.1.9. Transfer Pricing Information Requirements

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

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

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

C.1.1.9.4. An example of information requirements on transfer pricing in filing the annual income tax return is the related party transactions reporting form. One specific example is the Australian International Dealings Schedule that has to be filed with the annual corporate income tax return. Another example is the Brazilian Certified Digital Tax Bookkeeping (Escrituração Contábil Fiscal–ECF) where the taxpayer is required to report all transfer pricing transactions taking place on an annual basis. The South African transfer pricing questionnaire, required to be submitted with the annual corporate tax return, is another relevant non-OECD example.

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

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technological resources in place to be able to process and benefit from this information, as well as balance the information request with the level of burden to taxpayers.

C.1.1.9.6. Documentation requirements for transfer pricing are described further in Chapter C.3.

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

C.1.1.10.1. As mentioned in C.1.1.4.8. above, some tax systems contain a general recognition of the basic aspects of a tax obligation, and then issue extensive regulations explaining how the rules would apply in practice. For the purposes of this chapter, this essentially means recognizing the arm's length principle and the basic principles applicable to transfer pricing through the primary legislation.

C.1.1.10.2. There are some countries where all of the transfer pricing legislation is provided in the domestic substantive/primary tax legislation without further provisions through subsidiary regulations. Therefore, given the hierarchy of a substantive/primary law, the provisions are binding on the taxpayer and the tax administration.

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

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

C.1.1.10.5. Developing countries should assess which system is most suitable considering their own domestic tax legislation and the level of complexity they want to assume through the application of the transfer pricing legislation. Objective statutory provisions tend to provide greater certainty because they are binding on taxpayers and the tax administration. They are also likely to provide fewer margins for dispute, making the system clearer, which in turn puts less pressure on already limited human resources from the tax administration. Consideration should also be given on the status of rulings; e.g. in Australia they are administratively binding on the tax administration, but not on the taxpayer. See further Chapter C.6., paragraph C.1.3.2.2 and following for details on advance rulings.

C.1.2 Transfer Pricing Rules in National Tax Regimes

C.1.2.1. Domestic Rules

.1.2.1.1. Article 9 (Associated Enterprises) of the UN and OECD Models sets out the basic conditions for transfer pricing adjustments and for corresponding adjustments where there is a risk of double taxation. Although Article 9 endorses the application of the arm's length principle it does not set out detailed transfer pricing rules. The Article is not considered to create a domestic transfer pricing regime if this does not already exist in a particular country. Countries must therefore formulate domestic legislation to implement transfer pricing rules. Generally, countries apply their domestic transfer pricing rules to cross-border transactions, but some countries opt to apply transfer pricing rules also to domestic transactions. For such countries, this might be in recognition of the fact that their domestic tax bases can also be eroded through domestic transactions between related parties within

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the country, particularly where there are a number of different tax regimes in the jurisdiction (e.g. certain types of businesses or transactions that may be subject to different tax rates or special rules). Therefore, it is worth considering that when designing transfer pricing legislation, attention may also need to be given to compliance with the arm's length principle for transactions between related parties within a given jurisdiction.

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

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

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

C.1.2.2. Safe Harbour Rules

Introduction and Policy Considerations

.1.2.2.1. Safe harbour rules are rules that apply to a category of transactions, by allowing a defined category of taxpayers to follow simplified transfer pricing rules, or by exempting taxpayers from the application of the transfer pricing rules or from the application of transfer pricing documentation rules, as discussed later. Ideally safe harbour rules approximate outcomes under the arm's length principle to avoid double taxation or double non-taxation, or create market distortions. These rules could be limited to taxpayers with a magnitude or amount of controlled transactions below a threshold amount, expressed as a percentage or in absolute terms. The safe harbour rule can be relied upon by a taxpayer as an alternative to a more complex and burdensome rule, such as applying transfer pricing analysis, including a search for appropriate uncontrolled comparables. There are other types of simplified mechanisms for transfer pricing that certain countries also categorize as safe harbours. For example, another simplified mechanism sometimes used enables a company (generally smaller businesses or those with only limited international transactions) to avoid making a transfer pricing adjustment or having to keep transfer pricing documentation. A safe harbour is normally an obligation made available at the option of a taxpayer—it is generally regarded as a condition that the taxpayer can choose to

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apply or not. Other simplified or prescriptive rules which operate similarly to safe harbour rules but which operate on a presumptive basis rather than at the option of the taxpayer may also apply.

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

C.1.2.2.3. It is often stated that safe harbour rules allow tax administrations (especially those that are just beginning to administer transfer pricing laws) to focus their limited resources, including audit resources, on the more complex and higher risk cases. Given the difficulties of information availability, collection and analysis, many developing countries might consider that at least for SMEs or less complicated transactions, safe harbour rules can contribute to minimizing the complexity and burden of establishing transfer prices. The complexity and burden of establishing transfer prices might be disproportionate to the size of the taxpayer or its level of controlled transactions that are subject to the transfer pricing rules.⁷

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

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

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

C.1.2.2.7. There are possible downsides to safe harbour and other prescriptive rules, including the possibility of abuse or that the rules diverge from arm’s length outcomes. An example of such abuse is breaking down what is in reality a large transaction into several smaller ones to remain within the safe harbour threshold. There is also a risk that taxpayers’ lobbying efforts would make it difficult to remove safe harbours when capabilities have improved and the safe harbour or other prescriptive rules are no longer needed, or when conditions have changed so that such rules are no longer appropriate. There is also the possible risk that safe harbour rules are too generous; this can possibly result in revenue unnecessarily foregone. This will also be the case if transactions that would otherwise have been concluded at market prices are priced at the limit of the safe harbour. Or there may be a distortionary impact in that such a regime may encourage and perpetuate an economy based on small-scale or low-profit transactions rather than higher-risk/higher-reward transactions (e.g. technology

⁷ OECD Transfer Pricing Guidelines, paragraphs 4.95 to 4.100.

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based) to which the safe harbours will not apply. Safe harbours may thus even discourage investment in high-margin activity as compared to low-margin activities.

C.1.2.2.8. The section on safe harbours in Chapter IV of the OECD Transfer Pricing Guidelines discusses some potential disadvantages of safe harbour rules, such as the reporting of taxable income that is not in accordance with the arm's length principle, increased risk of double taxation or double non-taxation when adopted unilaterally, potential for creating inappropriate tax planning opportunities, and equity and uniformity issues due to the creation of two sets of rules for transfer pricing. In conclusion, where safe harbours can be negotiated on a bilateral or multilateral basis, they may provide significant relief from compliance burdens and administrative complexity without creating problems of double taxation or double non-taxation, which also can be achieved through unilateral safe harbour rules when the rules fall within the scope of double tax treaties (e.g. allowing the other State to understand the technical details behind the safe harbours in order to grant total or partial relief in case it is necessary and feasible). It is also stated that tax administrations should carefully weigh the benefits of and concerns regarding safe harbours, making use of such provisions where they deem it appropriate.⁸

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

C.1.2.2.10 When designing safe harbours, it is important to consider allowing for flexibility to “opt-in” or “opt-out” of said measure. Opt-in refers to a safe harbour in which the taxpayer can choose to “opt-in” in order to benefit from it. In this scenario, a taxpayer that chooses not to opt-in must apply the transfer pricing rules and document their application. An “opt-out” safe-harbour requires the taxpayer to apply the method specified to the transactions within the scope of said measure, unless it opts not to. If a taxpayer opts out, it must apply the transfer pricing rules and document their application, meaning that it bears the burden of proof that its controlled transactions were conducted in line with the arm's length principle. An “opt-out” regime will thus be a more straightforward option for many developing countries as it has the potential to reduce administrative costs.

C.1.2.3. Safe Harbour Practical Issues

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

C.1.2.3.2 The Organisation for Economic Cooperation and Development (*OECD*) has proposed a simplified approach in the form of fixed margin (5% mark-up on costs) in dealing with low value-adding services (*LVAS*)⁹. The OECD defines LVAS as services of a supportive nature, not forming

⁸ OECD, Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines, available at: <http://www.oecd.org/ctp/transfer-pricing/Revised-Section-E-Safe-Harbours-TP-Guidelines.pdf>.

⁹ OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/9789264241244-en>. Further, it was incorporated in Chapter VII of the 2017 Transfer Pricing Guidelines.

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part of the core business of the enterprise, and that does not use any intangibles or assume significant risks.

C.1.2.3.3 In addition, the Platform for Cooperation on Tax (PCT)'s toolkit for *Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses*¹⁰ includes a comparative analysis of the country practices in determining safe harbours to be applicable to LVAS (i.e. containing information on (i) definition of LVAS, (ii) excluded transactions and (iii) margin or mark-up for said safe harbour).

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

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

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

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

C.1.2.3.7. Although there are some exceptions, according to the tax rulings of each country as well as tax treaties, the safe harbour regime may include provisions and regulations of the procedure for applying for MAP. The time depicted in the process and the success of the claim will depend on the treaty partner and the type of transactions under request.

C.1.2.3.8. As an option for the safe harbour, tax authorities may also allow taxpayers to apply for APAs to comply with the transfer pricing regime.

C.1.2.4. Downwards Adjustments

C.1.2.4.1. Since implementation of transfer pricing rules usually result in adjustments that increase the amount of tax payable, a taxpayer may seek, on examination, a reduction in a transfer pricing adjustment and in taxable income, arising from unintentional over-reporting of taxable income. Guidance provided in the OECD Transfer Pricing Guidelines indicates that tax administrations may or may not grant the request for downward adjustment at their own discretion.¹¹ Furthermore, tax administrations may also consider such requests in the context of MAP and corresponding adjustments.

¹⁰ Platform for Collaboration on Tax (PCT) (2017), "Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses", <http://documents.worldbank.org/curated/en/447901498066167863/pdf/116573-REVISED-PUBLIC-toolkit-on-comparability-and-mineral-pricing.pdf>.

¹¹ OECD Transfer Pricing Guidelines, paragraph 3.17.

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This is an issue which developing countries should also consider when designing their domestic legal environment for transfer pricing.

C.1.2.4.2. The Republic of Korea's experience may be considered as an example in this regard. In 2010, the Republic of Korea clarified in its tax law that a downward adjustment should be applied in cases where a tax adjustment is made under a transfer pricing method using multiple year data. Therefore, tax officials are no longer given any discretion to make the adjustment only for years with a deficient profit, and to disregard years with excess profits, when they adjust the taxpayer's profit level under a transfer pricing method using multiple year data.

C.1.2.4.3. In South Africa, the legislative provision that requires that terms and conditions should be adjusted to those that would have existed had the parties been independent persons dealing at arm's length, is limited to situations where the taxpayer will always make adjustments that favour tax administrations, but may be much less likely to do so for adjustments that do not. The over-reporting of taxable income would not fall within the meaning of a tax benefit.

C.1.2.4.4. The Mexican tax administration issued rules for the application by taxpayers of transfer pricing adjustments (i.e. upwards and downward adjustments). The rules (i) define the notion and types of "transfer pricing adjustments", (ii) timing of application, (iii) indicate the information that has to be compiled by taxpayers regarding said adjustments; (iv) explain the effects that may arise with regards to line items related to withholding and (v) address consequences of the adjustments on indirect taxes (VAT).

C.1.2.4.5. It is also important that provisions for downward adjustments do not create opportunities for non-taxation. For example, taxpayer A in country A makes a request to decrease the price of goods sold to related party B in country B from 100 to 80 in accordance with the arm's length principle, thereby lowering its income by 20. The newly determined arm's length price implies that the income of B should be increased by 20. However, if this corresponding upward adjustment is not made the 20 of income will be taxed in neither country. This risk of double non-taxation is highest in cases where a taxpayer has initiated a request outside of a MAP or APA process, and information on the position of the related party, or parties, in the other jurisdiction(s) is missing.

C.1.2.4.6. Where the taxpayer has initiated downward adjustments, and a tax administration accepts in principle that a downward adjustment should be made, the taxpayer may be required to provide evidence that the amount has been included in income by a related party in the other jurisdiction. Alternatively, the competent authority of the country agreeing to the downward adjustment should spontaneously exchange information about the downward adjustment with the competent authority of the other jurisdiction, so that the latter competent authority can consider whether additional income should be recognized in its jurisdiction. "

C.1.2.5. Advance Pricing Agreements/Arrangements

C.1.2.5.1. Many countries have introduced APA procedures in their domestic laws though these may have different legal forms. For example, in certain countries an APA may be a legally binding engagement between taxpayers and tax authorities, while in other countries it may be a more informal arrangement between the tax authorities and the taxpayer. APAs are a useful dispute avoidance mechanism and are discussed in further detail in Chapter C.6. including the considerations for proper operation of APA procedures and the advantages and disadvantages of APAs. It may, however, be noted that consideration must be given to the inclusion of an APA programme at different stages of the design of a legal framework for transfer pricing.

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C.1.2.5.2. When implementing APAs, tax administrations have to bear it in mind that the APA process is, in practice, a service to taxpayers. Consequently, appropriate capacity must be installed in the tax administration in order to adequately respond to taxpayers' demand in terms of response time, volume of requests, complexity of cases, etc. In addition, within a legislative design context, taxpayers may be required to pay fees when filing an APA request to cover the actual costs of processing APA requests.

C.1.2.5.3. Some consider adequate levels of experience to be necessary before the appropriate type of APA can be achieved, while others see the experience gained in concluding APAs as an important part of capacity-building on transfer pricing issues. Matching operational capability to offer APAs with operational capability of the transfer pricing regime is thus an important factor in the design of the domestic legal environment.

C.1.2.5.4. Some countries choose not to have APAs, at least for some time after their transfer pricing regime is put in place. For example, they may feel that they need to develop capacity and skills before they can properly evaluate what is an appropriate APA system for them.¹² Other countries are concerned that APAs are not useful in a transfer pricing regime because they tend to be sought by companies that are in broad conformity with the arm's length principle and may divert scarce resources from achieving compliance in the worst cases of avoidance. As with any such mechanism, checks and balances must be provided to ensure that the APA process is applied consistently between taxpayers and is not subject to abuse or integrity issues. The issues involved in balancing resource issues and priorities with the potential benefits of APAs are discussed in more detail at Chapter C.6. (C.6.3.5.6. ff)".

C.1.2.6. Interaction of Transfer Pricing Provisions with Other Cross-border Rules

C.1.2.6.1. In designing a domestic tax system, consideration must be given to the interaction of transfer pricing rules with Controlled Foreign Corporation (CFC) rules. CFC rules are designed to prevent tax being deferred or avoided by taxpayers using foreign corporations in which they hold a controlling shareholding in low-tax jurisdictions. Without CFC rules income could be left in low tax jurisdictions and remain outside the scope of domestic tax rules. CFC rules treat this income as though it has been repatriated and it is therefore taxable to the resident shareholders. It is widely considered that the transfer pricing rules should have priority and the CFC rules should apply to the profits remaining in controlled foreign companies after application of the arm's length principle.

C.1.2.6.2. It may sometimes be more advantageous for tax purposes to finance a company by way of debt than of equity as the interest paid on debt may be deducted for tax purposes while dividends on equity may not be tax deductible. In many countries thin capitalization provisions have been introduced to deny a deduction for excessive interest payments. This is done by prescribing a maximum debt-to-equity ratio or (net) interest to EBITDA and disallowing a proportion of interest payments if debt exceeds this maximum level (see section B.1.7.8.). These rules protect the tax base by discouraging cross-border shifting of profits through excessive interest payments on debt. From a policy perspective, failure to tackle base eroding interest payments gives MNEs an advantage over purely domestic businesses which are unable to gain such tax advantages.

C.1.2.6.3. Some countries that do not have very detailed transfer pricing rules in place may deal with abusive forms of transfer pricing through the use of a general anti-avoidance rule (GAAR). Abusive non-arm's length transactions may come within the scope of the GAAR. This may be useful in the early stages of introducing a transfer pricing regime, however use of the GAAR in transfer pricing

¹² After almost a decade of experience of implementation of transfer pricing regulations in the country, India introduced APAs with effect from 1 July 2012 in the Income Tax Act. Financial Year 2013-14 was the first year that APAs came into effect. Since then India has signed more than 100 unilateral and bilateral APAs.

issues may create uncertainty for business and detailed transfer pricing legislation, regulations or guidance may thus be preferable.

C.1.3. Keeping Transfer Pricing Regimes Updated

C.1.3.1. Gathering Information

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

Regional coordination through existing intergovernmental agencies

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

C.1.3.1.3. These are non-profit international public organizations that may be able to provide specialized technical assistance for the modernization and strengthening of tax administrations in different regions of the world, through conferences, targeted field missions, exchange of information, and sometimes even targeted training. As their names indicate, they tend to cater for a specific geographic region, or a particular group of countries unified through their similar characteristics. Some countries are members to more than one regional organization:¹³

- CIAT's predominant membership is from the Americas,¹⁴
- ATAF's membership is primarily of African countries,
- SGATAR's membership is located in the Asia-Pacific region, and
- CATA's membership draws from a number of Commonwealth countries spread over all geographic regions of the world.

Engagement with institutional stakeholders

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

¹³ For example, Australia is a member of both SGATAR and CATA.

¹⁴ There is a special category of associate member. CIAT's General Assembly may accept as Associate Members countries from regions other than the Americas that apply for accession and have the approval of the Executive Council. There are currently 5 European countries, 2 African countries and 1 Asian country in CIAT's membership.

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C.1.3.1.5. Some national and regional tax administrations also provide very good guidance in the field of international taxation in general, and transfer pricing specifically, in areas where they themselves face difficulties in compliance and policy formulation, as well as providing their interpretation of certain international tax provisions. These national tax administrations, regional organizations and others could be followed and even consulted by developing countries wishing to resolve perhaps similar problems arising as a result of the application of their own transfer pricing rules.

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

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

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

C.1.3.1.8. By acting within an organized group, tax administrations can share training expenses while promoting capacity development, disseminating knowledge, organizing joint seminars, sharing training content received from intergovernmental institutions such as member of the Platform for Collaboration on Tax, and also bid for capacity development funding from donor agencies, foundations and other agencies. The Platform for Collaboration on Tax has issued a number of toolkits, which should be an important resource in capacity development.

Participate in the South-South dialogue for capacity development

C.1.3.1.9. In general, tax authorities in developing countries lack sufficient qualified and experienced personnel to understand the concerns of MNEs and to deal with controversial transfer pricing issues, especially in view of global developments around new, rapidly developing topics such as BEPS. Regular training, information exchange and experience sharing and even foreign language skills, are all examples of aspects that are necessary for capacity development. A knowledge sharing platform with other tax authorities (a regional institution, or a clearing house institution) could be an important step in this regard. International secondments to gain more experience at the United Nations, the OECD or in another tax administration should be considered if possible. An independent external consultancy body might also be an option, as explained below. Other capacity development issues are covered in detail in Chapter C.2.

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

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

C.1.3.2. Examples of Measures to Update Transfer Pricing Regimes

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

Advance tax rulings

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

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

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

C.1.3.2.5. Depending on the design of tax rulings, they can be a useful starting point in avoiding disputes between the taxpayers and tax administrations as discussed in Chapter C.6.

Establish an international consultancy body

C.1.3.2.6. Developing countries might benefit from establishing an independent organization (an expert body, composed of academics, industry experts, and/or government officials) to advise them on the ways through which they might be able to fine tune or update their legislation. An independent advisory group could suggest updates, point out controversial issues in the country's legislation, suggest action in certain transfer pricing areas, and even audit the country's tax legislation for improvement.

C.1.3.2.7. Developing countries should, through participation in regional and global dialogues, be able to benefit from the use of existing consultancy bodies used by countries with similar legislation, or countries located within the same geographic region. This should help manage costs if countries opt to be evaluated contemporaneously with each other. The effort could be hosted in an existing cooperation organization, as mentioned above, or within a UN specialized organization to further manage costs. Regional organizations, such as ATAF and CIAT, are known to have also provided similar capacity for their member countries.

ANNEX C: C.2 -ESTABLISHING CAPABILITY

[This Chapter was formerly C.5)

C.2. ESTABLISHING TRANSFER PRICING CAPABILITY IN DEVELOPING COUNTRIES.

C.2.1. Introduction

C.2.1.1. This Chapter addresses issues involved in setting up a dedicated transfer pricing unit in the tax administration to administer the country's transfer pricing rules. There are important opportunities as well as challenges in setting up such a unit for the first time. The design of such a unit, its vision and mission statement and the measurement of whether it has been successful will have to take into account factors such as:

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

C.2.1.2. These points provide a useful framework when setting up a transfer pricing unit. There is no perfect "template" that will be suitable for all countries in every respect. These issues will all need consideration in the context of the country's overall tax administration and legal structures.

C.2.2. Relationship between Tax Policy and Tax Administration

C.2.2.1. In most countries, the tax policymaking function generally resides with the Ministry of Finance rather than with the tax administration. The other revenue generating organs of government (e.g. the customs service)¹⁵ are also usually separate from the tax administration. There is, however, a particular need to bridge the gap between the policymaking function and the tax administration in order to implement an effective transfer pricing regime. This need arises due to:

- The complexity and resource intensiveness of administering a transfer pricing regime;
- The potential costs of compliance for taxpayers and of collection by tax administrations;

¹⁵ Customs are relevant for transfer pricing in relation to issues of valuation. See for example the discussion at Chapter B.2., paragraph B.2.4.7. of this Manual and World Customs Organization, *WCO Guide to Customs Valuation and Transfer Pricing* (2015); available at: <http://www.wcoomd.org/en/topics/key-issues/revenuepackage/~media/36DE1A4DC54B47109514FFCD0AAE6B0A.ashx>.

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- 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.

C.2.2.2. The respective responsibilities and functions of the tax administration and of the policymaking function should be clear. Mechanisms for contact and coordination between the two should be well understood. Duplication and overlap of functions should be avoided, and processes for coordination between the two should be streamlined.

C.2.2.3. Some factors that could improve cooperation between the tax administration and the policymakers 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 the design of that regime and in its administration, and so that practical lessons from the administration of the regime by the tax administration can provide feedback in order to fine tune policy. Examples are:
 - Where aspects of the policy are expensive or otherwise very resource intensive to administer, and the likely revenue return is not commensurate with these costs;
 - Where a wider treaty framework and strong exchange of information provisions would be beneficial; or where there is a need to ensure that the framework of thresholds, deterrence mechanisms, and penalties is effective and up to date; and
 - Where the experience of the administration and competent authorities in taxpayer service, education, enforcement, and case resolution can aid in improving legislation or implementing regulations;
- Cross-secondment of tax administrators and policymakers to each other’s teams can help ensure that administration officials understand the policymaking process and the objectives of the legislation, and that policymakers understand the practical issues of tax administration. Good tax policy must be capable of being administered and good administration must have sound policy underpinnings; and
- Involvement of the tax administration in developing investment policies, including involvement in discussions about tax incentive and tax holiday policies that may affect transfer pricing and other aspects of tax administration.

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

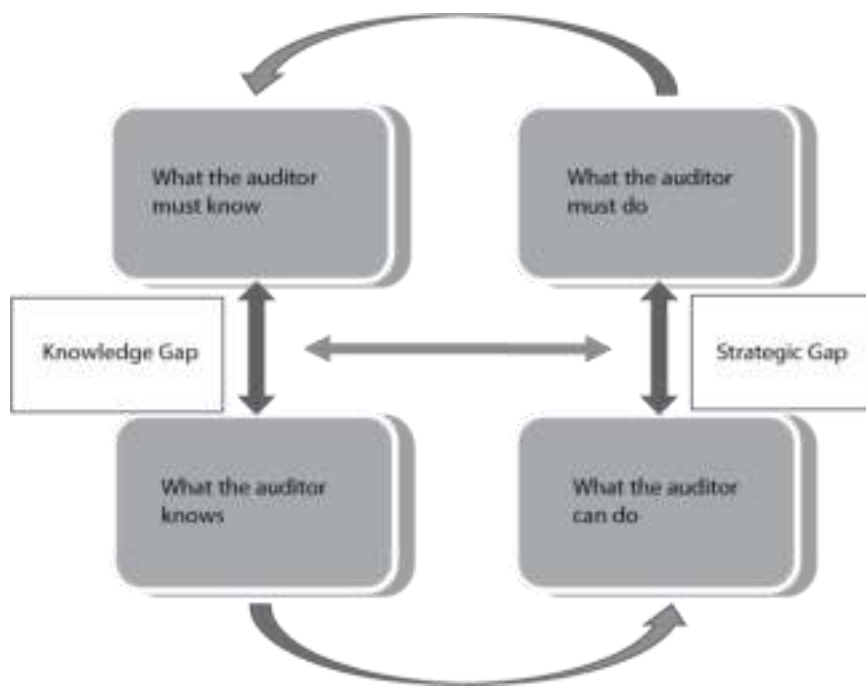
C.2.3.1. Different tax administrations require different types of administrative arrangements when it comes to implementing the particular country’s transfer pricing policies. The level of development/capability in the tax administration should be a key factor to consider when formulating policies. In many cases, there is an unrealistic expectation that increases in capability across too many areas can be achieved in a short time. Skill in administering transfer pricing rules can only be developed by practical experience in addressing actual transfer pricing cases.

C.2.3.2. In addressing the issue of building transfer pricing capability it is important to realistically evaluate the actual level of existing knowledge and the best organizational approach. The focus in this Manual is on countries with little or no existing experience in transfer pricing, so there are initial start-up issues. There is also a recognition that not everything can be achieved at once and that the system and the administrative capability will need to evolve over time through practical experience

and as part of a capacity building plan. This is sometimes termed a “life cycle approach”. A possible approach is outlined below in Figure C.2.1.¹⁶

Figure C.2.1:

Audit Process



C.2.3.3. 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 C.1.) including the characteristics of the transfer pricing legislation and responsibilities for and the scope of regulations. A clear and transparent legal framework is important to the functioning of the administration as a whole;¹⁷
- 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

¹⁶ 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).

¹⁷ Katherine Baer, Olivier Benon, Juan Toro, *Improving Large Taxpayers’ Compliance: A Review of Country Experience*, (Volume 215 of *International Monetary Fund, Occasional paper*, 2002). Available at <http://www.imf.org/external/pubs/nft/op/215/>.

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- 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 availability of personnel skilled in using such systems.

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

C.2.4.1. Objectives

C.2.4.1.1. The objectives of the transfer pricing team should be clear, both to team members and to others that they are engaging with. This includes other persons in the administration, those involved in the tax policy function, and stakeholders such as taxpayers and their advisors. Often this is put in terms of developing a “mission statement” reflecting what the transfer pricing unit will do in its daily operations and a “vision” representing what an ideal future will look like when the unit carries out its mission properly. Many tax administrations also have a “Taxpayer’s Charter” which reflects what taxpayers can expect from the administration, and what is expected from taxpayers in their relationship with the administration.

C.2.4.1.2. Documents reflecting the mission and the vision should become part of the culture and be “lived out” by the unit on a daily basis. This will be assisted by, for example, developing a team charter aligned with the wider organizational charter agreed by senior managers in the transfer pricing unit and key persons in the tax administration as a whole, preferably after conversations with stakeholders. This could usefully draw upon the experience of other countries though it must be tailored to each country’s own realities. It is of course necessary to monitor the achievement of the mission and vision in practice and, if the mission and vision have not been achieved, to identify the reason for that.

C.2.4.1.3. An important part of defining the unit’s objectives involves identifying and recognizing the limitations on available resources. Clearly determining what is inside and outside the competence of the unit will help clarify what resources are needed to meet the objectives of the unit and encourage the best use of such resources.

C.2.4.2. Client/Taxpayer Orientation

C.2.4.2.1. A central consideration to be borne in mind is that a transfer pricing unit will have important taxpayer service and education functions as well as a central enforcement function. These functions are interrelated: better education and taxpayer service reduces the cost, resource-intensiveness and “pain” of compliance. This, in turn, helps increase compliance (those wanting to comply find it easier to do so) and allows the administration to focus enforcement measures on the greatest risk areas (in particular, on taxpayers who have no intention of complying with their obligations).

C.2.4.2.2. Understanding the functions and environment of MNEs will further the tax administration’s service, education, and enforcement activities. Handling their taxation issues will inevitably lead to more contacts between MNEs and the transfer pricing unit. For instance, MNEs have to disclose their documentation and systems, while tax administrations have to be aware of the dangers of unnecessarily high administrative burdens, and therefore compliance costs, for MNEs. High compliance costs are inefficient and may unnecessarily give a negative view of a country’s investment climate, deterring potential investors.

C.2.4.2.3. On the other hand, increased focus on transfer pricing issues will inevitably lead to some disputes with MNEs and the possibility of double taxation. For example, in a related party transaction involving entities in two countries (A and B), Country A might assert that more profits from the transaction are subject to its tax jurisdiction in accordance with a bilateral treaty, resulting in fewer

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profits being (in Country A's view) subject to tax in Country B. This is an increasingly common issue in transfer pricing and tax administrations need to devote sufficient resources to avoid unnecessary differences of opinion. They need to ensure, where possible, that those differences do not lead to unnecessary disputes and they need to deal with formal dispute resolution procedures as expeditiously and effectively as possible when a dispute cannot be avoided.

C.2.4.2.4. Most double tax treaties contain a Mutual Agreement Procedure (MAP) article (usually Article 25), based upon the UN or OECD Model Tax Conventions, that is designed to avoid double taxation. However, MAP 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. See *** for details on MAP.

C.2.4.2.5. Engagement with taxpayers and their tax advisors is necessary to understand the transfer pricing systems and practices of MNEs, and for the MNEs to understand what is required from them in a newly introduced transfer pricing regime. This will help taxpayers and the tax administration to explore shared interests in clarity, transparency, and certainty, to understand and reduce the risks of aggressive tax positions, to increase awareness of commercial realities, fairness and consistency between taxpayers, and to reduce the costs of compliance and collection.

C.2.4.2.6. There is a need for considerable early investment in taxpayer education. The tax administration also needs to ensure professional and effective relationships with taxpayers as an element of taxpayer service. This is one area where the experience of other similarly placed administrations is likely to be especially helpful.

C.2.4.2.7. 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.

C.2.4.2.8. 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 continuous dialogue with taxpayers, tax professionals, their associations or peak representative bodies on tax issues;
- Being reasonable and proportionate in actions, and open and transparent with taxpayers;
- Being responsive to requests;
- Extensive and clear taxpayer education, including making tax guidance notes available to taxpayers, information circulars and other guidance on interpretation of tax laws to avoid misunderstandings, confusion and surprises to those willing to meet their obligations;
- An informative and easy to navigate Internet presence that is regularly tested and kept under review for its user-friendliness and relevance;
- Seeking to avoid disputes arising unnecessarily but also setting up clear and fair systems for addressing such disputes that do not unfairly deter taxpayers from pursuing legitimate grievances; and
- Providing a process for obtaining advance rulings and advance pricing agreements on specific issues of taxpayers.

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C.2.4.2.9. 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 (see 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 (***)¹⁸;
- Making their transfer pricing policy available to the tax administration as part of the required documentation;
- Recognizing the resource limitations on the side of the administration and not “playing games” to tie up those resources unnecessarily to the disadvantage of the administration and other taxpayers; and
- Complying with the requirements of the bilateral double taxation treaty between the country they are operating in and their country of residence, and understanding the circumstances when the applicability of the tax treaty to them may be denied.

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

C.2.4.3.1. 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.

C.2.4.3.2. Issues and procedures related to risk assessment and management are considered in more detail in Chapter C.4. of this Manual. In setting up a transfer pricing unit, however, it should be recognized that there is an important role for officers attuned to the organization’s approach to risk management and able to implement it systematically for a new area and keep it under review. Consistent risk management strategies will often be developed in conjunction with other areas of the administration, such as those dealing with tax treaties, or those clustered around relevant industries or in offices that are differentiated based on the size of a taxpayer.

¹⁸ The issue of whether to institute an APA programme is a complex one, which is addressed in Chapter C.6. of this Manual. 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.2.4.3.3. As part of this risk management approach, it is important to identify the areas of focus. For example, 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.¹⁹

C.2.4.3.4. The criteria referred to above will have to be assessed for each country in the light of its own circumstances, and will have to be kept under review to make sure these criteria are not relied on abusively so that the risk profile has changed.

C.2.5. Organizational Structure for the Transfer Pricing Unit

C.2.5.1. Introduction

C.2.5.1.1. An important part of implementing a transfer pricing regime is determining which part of the tax administration should undertake transfer pricing work. The generally observed options include:

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

C.2.5.1.2. In addition to one of the three options above, tax administrations also have the option of creating specially designated departments within other departments, to deal with high profile cases, special cases or with certain groups of taxpayers. In this case, countries might also consider creating the following sub-departments:

- Placing the work within a Large Taxpayers Unit/Office (LTU/LTO) and building up capacity of officials working within that office in transfer pricing.
- Developing transfer pricing capacity in specific industry focused units which the tax administration considers to be particularly susceptible to transfer mis-pricing—e.g. pharmaceuticals, oil and gas, automotive, etc.

C.2.5.1.3. The choice to be made by a particular country will depend on its particular circumstances and capacity. The choice may also be dynamic. For example, in the early stages of the regime being implemented, the transfer pricing work can be concentrated in the part of the tax administration that deals with international tax issues. As capacity is built and more cases are seen, a new section can be created within the LTU/LTO where the most high-profile cases may be expected to emerge. Over time, more specialist knowledge can be built up and spread wider across the tax administration.

C.2.5.1.4. Taxpayer segmentation has been implemented across the world, which allows the tax administration to create centres of competence dealing with separate taxpayer types. Such units are often part of a reformed administration that includes structuring the administration along functional lines, focusing on the taxpayer as the administration's "customer". A principal objective of taxpayer

¹⁹ 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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segmentation is to minimize compliance costs. It is quite common to allocate the transfer pricing inspection division to the LTU/LTO, which is then considered the central repository of experience.

C.2.5.1.5. Such an allocation of responsibilities can foster evolving and increasing learning approaches. A good example is Brazil where the transfer pricing programme in the LTO (known as the DEMAC) focuses its audits mainly on specific sectors such as pharmaceuticals and automobiles. However, as the audit teams continue to grow in sophistication in their approaches, and also in number and experience, the focus has become broader.

C.2.5.1.6. Finally, the design of a good tax administration must include an effective audit programme capable of detecting and penalizing non-compliant taxpayers. Such an audit programme could grow out of a larger compliance team, and could include industry and/or issue-oriented audits, comprehensive regular audits of specific businesses that fall within risk criteria and fully-fledged tax fraud investigations. Joint investigation programmes to deal with suspected cases of non-compliance for corporate income tax and indirect taxes, such as value added tax, may also be planned by more sophisticated tax administrations. See further Chapter C.5 on Transfer Pricing Audits.

C.2.5.1.7. Public consultation with business and stakeholders prior to implementation or modification of a particular piece of legislation may help create more common understanding between the taxpayer and the tax administration. This will help likely reduce potential future disputes by allowing time for taxpayers to foretell the issues that might cause greatest concern in the proposed legislation.

C.2.5.1.8. Use of information and communication technology (ICT) in tax administration is now a central part of capacity development. Tax administrations should consider use of ICT to increase transparency in the tax system and to automate processes. An increase in transparency means making information more readily available, without the need for personal contact. The automated communications system can provide relevant stakeholders with online access to templates, case studies, step-by-step guidelines (even if informal guidelines of no legal status), explanation of legislative changes, publication of pre-selected information geared towards specific industries or types of taxpayers (e.g. information pertinent to small and medium enterprises, separate information for large taxpayers, one for automotive, pharmaceuticals, etc.). Automation of processes would include introduction or extension of electronic filing of transfer pricing related compliance obligations, and possibly the use of trusted third-party platforms. These measures have the potential to significantly reduce business compliance costs, improve taxpayer confidence and increase simplicity; they may also support anti-corruption initiatives and improve perceptions.

C.2.5.2. Establishing Transfer Pricing Capability: Possible Structures

C.2.5.2.1. There are two basic types of structures that can be adopted for establishing transfer pricing capability: a centralized model, with a single transfer pricing unit operating across all industries and geographical areas, or a decentralized model, with separate transfer pricing units by industry or geography. Each has advantages and disadvantages, as follows.

C.2.5.2.2. A **centralized model** presents the following advantages and disadvantages:

- *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

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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.2.5.2.3. A **decentralized model** presents the following advantages and disadvantages:

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

C.2.5.2.4. 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.

C.2.5.2.5. 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.

C.2.5.2.6. The benefit of a “one stop” contact point is also one of the reasons why many administrations have LTOs, often with specific industry contact points, to handle relationships with MNEs and other large taxpayers especially in key sectors of the economy such as resource extraction. These offices can respond in an integrated fashion to diverse issues across different subject areas (for example: income tax, VAT and resource royalties) as well as issues of particular importance for some taxpayers such as transfer pricing and thin capitalization. They usually have auditing, registration, tax accounting, collection and taxpayer service roles and are sometimes seen as especially useful when implementing new approaches, including major policy or administrative reforms such as self-assessment or computer modernization of the tax office as an “incubator” for change elsewhere.

C.2.5.2.7. 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.

C.2.5.2.8. 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.

C.2.5.2.9. 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.

C.2.5.2.10. As noted above, some countries also have a separate office dealing with large MNEs because of their specific characteristics, their relevance in terms of investment, the tax revenue they may generate, and the related tax issues that are of special importance. Such an office can be organized on a national level or within the regions, depending on the number of MNEs that are active in the country. As noted above, this unit should as far as possible act as a central contact point (or "one-stop shop") for responses on MNE issues and it will therefore need to contain transfer pricing expertise or at the very least work especially closely with the transfer pricing unit.

C.2.6. Building Team Capability

C.2.6.1. General Human Resource Management Issues

C.2.6.1.1. A new transfer pricing regime may often be created as part of major changes within a tax administration, such as recognition of the impact of globalization and international value chains on the particular country. As with most changes there are potential advantages and disadvantages. While the human resources management strategy for the unit needs to be integrated with the organization's wider human resources strategy, there are aspects that are likely to be of particular relevance in this area, including the importance of:

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

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

C.2.6.1.2. Practice has shown two particular human resources–related risks at this stage. First, there is the possibility of resentment against those involved with transfer pricing policy and administration by others in more “established” areas. Because it is new, people within the organization do not always know exactly what it is about and feel uncertain. They can be unwilling or dismissive about taking up transfer pricing issues. Further, setting up a transfer pricing unit may require the recruitment of outside expertise in key roles. Existing staff may feel it is a “fashionable” area of work that draws resources and support away from their own equally important areas of work, or unduly rewards “outsiders” and “upstarts” who have not “paid their dues”. The interrelationship and equal importance of different aspects of the organization’s mission and vision need to be emphasized and “buy-in” established with other parts of the organization. However, it has to be stressed that building up capability in this area will involve new approaches and bringing in some fresh perspectives and new skill sets. The unit should not have a sense of superiority as part of its culture, but rather a sense of the importance of its work and of the opportunities to pursue broader organizational goals while furthering personal development.

C.2.6.1.3. The link can be established between an effective transfer pricing response and a more effective response by the organization to more general tax issues. Efforts can be made to have transfer pricing information and training sessions for officers elsewhere in the organization. This can reduce any impression that transfer pricing is a “black box” known only to members of the transfer pricing unit (or, even more importantly, that the unit and individual unit officers want to keep it that way) and can emphasize natural linkages to the other work of the administration, such as thin capitalization or treaty negotiation and administration. Conversely training in how particular industries operate, especially ones that are especially large in a country, proportionate to other industries (such as mining,

oil and gas, or telecommunications in many countries) will greatly help increase the effectiveness and focus of transfer pricing experts.²⁰

C.2.6.1.4. There is, on the other hand, a risk that employees from the tax administration will become overly enthusiastic about transfer pricing as a “panacea”—a solution to all problems—and may, accordingly, propose unjustified or disproportionate tax adjustments leading to time consuming litigation and MAP proceedings. It is often stated that transfer pricing is not an exact science, and there is a broad range of possibilities to discuss and adjust tax returns. That inexact quality can be abused by authorities as well as by taxpayers. It is thus important to manage this process, and ensure that any proposed transfer pricing adjustment is justified on purely transfer pricing grounds; it is also important to show that the discretion implicit in such an inexact situation is properly exercised. This involves integrity issues and it is important that decisions taken having major financial impact are appropriately checked and “signed off” in a way that not only ensures (as far as possible) that they are made for the right reasons and consistently with the treatment of other taxpayers, but that they are also seen as doing so.

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

C.2.6.2.1. Recognizing the many aspects of transfer pricing and that the unit will have educative and taxpayer service functions as well as an enforcement role, a transfer pricing unit should ideally include, or have ready access to, the following skill sets:

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

C.2.6.2.2. 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.²¹

²⁰ Alexandra Readhead, *Preventing Tax Base Erosion in Africa: A Regional Study of Transfer Pricing Challenges in the Mining Sector* (Readhead, 2016), Natural Resource Governance Institute, July 2016, p. 26. Available at http://www.resourcegovernance.org/sites/default/files/documents/nrgi_transfer-pricing-study.pdf.

²¹ Readhead, 2016, p. 24.

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C.2.6.2.3. Dealing with MNEs demands specific characteristics and competences. Transfer pricing is about how business operates and the application of complex tax laws and economic principles to those business operations. Knowledge of international taxation and good judgment is required to select the right areas to focus on and the right cases for an audit, as some transactions are more tax-driven than others. The ability to interpret information, and to sort the relevant from the irrelevant is becoming ever more important as the opportunities to obtain information from other tax administrations and from MNEs themselves increases. Having information available but being unable to properly interpret it may put an administration in a worse position, especially before the courts, than if it never had access to the necessary information.

C.2.6.2.4. 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.

C.2.6.2.5. 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.

C.2.6.2.6. 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.²² It was noted that such experts can share their experience and give auditors, for example, more confidence in demanding information from taxpayers.²³

C.2.6.2.7. A key challenge of working closely with taxpayers is that many of the best trained experts from the tax administration are likely to eventually leave to join the private sector. This will have an effect on individual cases as well as on the operation of the unit more generally. As noted in more detail below, a system designed to capture and spread knowledge of transfer pricing issues within the unit, which includes team involvement, effective management, and regular review of cases, will help to minimize the effects of these departures, as will an effective system of recording and filing relevant transfer pricing opinions and material relating to particular cases. In any case, such interplay of “cultures” between the administration and the business sector over time can be useful for each of these entities; it helps each to understand what drives the other and what the expectations are.

C.2.6.2.8. 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.

²² Readhead, 2016, p. 25.

²³ Readhead, 2016, p. 25.

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C.2.6.2.9. Integrity issues may arise from the close contacts between business and the tax administration, the large amounts of money often at stake, the fact that transfer pricing requires the exercise of discretion and judgment in determining appropriate outcomes, and the fact that transfer pricing analysis often gives a range of results rather than a single clear answer. These issues can be exacerbated by a trend of many tax officials engaged in transfer pricing issues later moving to the private sector. The best way to deal with these issues is by having discussions with MNEs in teams, and ensuring that records are kept of those discussions. The records should be internally reviewable to ensure that the proper policies and practices have been followed and to make sure a consistent approach has been adopted between taxpayers. This helps to ensure that working arrangements are transparent, open and incorporate built-in checks and balances that will reduce the risk of temptation on both sides. It is also important to recognize that officers should be given protection from false accusations against their integrity, which may reduce their willingness to approach each case fairly and impartially. The checks and balances should be designed to support officers acting properly and maintain the effectiveness of the unit. A way for officers to bring issues of integrity to management attention through secure channels that will act on such intelligence without punishing the whistleblower and discouraging such behaviour in future should also be considered.

C.2.6.2.10. 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.

C.2.6.2.11. 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.²⁴

C.2.6.2.12. 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.

C.2.6.2.13. 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.

C.2.6.2.14. 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

²⁴ See, for example, the discussion in Readhead, 2016, pp. 36-38.

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.

C.2.6.2.15. 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.2.6.3. Training

C.2.6.3.1. In some countries the educational system provides a steady supply of accountants, auditors, economists and lawyers from which the tax administration can draw. In other countries the situation is more difficult either because the formal educational system does not produce enough qualified graduates or because there is more competition, especially on salaries, from the private sector. This will affect the type of training required and it is of the utmost importance to assess the knowledge, capabilities and competencies of officers.

C.2.6.3.2. 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.

C.2.6.3.3. 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.

C.2.6.3.4. 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.

C.2.6.3.5. 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.

C.2.6.3.6. 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.

C.2.6.3.7. 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.²⁵ Training in management, negotiation and inter-personal/relationship building skills will also be very important. So too will be knowledge management, project planning, database and other IT skills. Ethics training can be helpful in ensuring that officers are aware of ethical considerations in their new role as well as more formal legal rules of conduct, and of the way in which these interact (especially as to the exercise of discretion).

C.2.6.4. Research Materials/Databases

C.2.6.4.1. 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.

C.2.6.4.2. 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.

C.2.6.4.3. 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.

²⁵ Readhead, 2016, p. 26.

C.2.6.4.4. 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.²⁶

C.2.6.5. Information Strategies

C.2.6.5.1. 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.

C.2.6.5.2. Information strategies will be needed to deal with such technology and the way information is held. Taxpayer files need to be held securely but centrally, so that it is clear what has been requested of taxpayers and when, as well as what has been received and when. It should also be clear when materials have been accessed and by whom among the authorized persons, as well as whether information has been downloaded. A data back-up policy will be needed, with measures to ensure that no data are lost if there is a corrupted or lost back-up (such as duplicate backups held in different locations, with the immediately previous backups being retained also). It is important that documents are not lost or destroyed and that the large volume of paperwork that is a characteristic of transfer pricing cases is not overwhelming, but is securely held. The possibility of litigation on transfer pricing issues must always be borne in mind, even though it should be seen by both sides as a last resort.

C.2.6.5.3. Some countries require material to be provided in electronic form, and others require or encourage an index system for the documents provided and a description of the record-keeping system used. If such information is electronically searchable then, subject to the availability of the necessary software and skills, there are potentially great resource savings in dealing with often very large files, speedier response times, and less chance of information being lost. The cost to taxpayers of providing material in certain forms should always be considered in deciding what should be required under relevant legislation or regulations.

C.2.7. Effective and Efficient Business Processes

C.2.7.1. 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.

C.2.7.2. 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

²⁶ IMF/OECD/UN/World Bank: A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses, 22 June 2017. Available from <http://documents.worldbank.org/curated/en/447901498066167863/pdf/116573-REVISED-PUBLIC-toolkit-on-comparability-and-mineral-pricing.pdf>.

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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.

C.2.7.3. There will generally be discretion provided in the legislation or regulations of the transfer pricing regime in any case. Such discretion 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 discretion and a system of overseeing how they are exercised in practice will be needed.

C.2.7.4. Owing to the amounts of money at stake in many transfer pricing cases, and perhaps the fact that government transfer pricing experts often eventually leave for the private sector, strong checks and balances are required when decisions are made affecting taxpayer liabilities to tax. On the reverse side, it needs to be clear that the unit is not anti-business, but recognizes the way business inherently operates, the need to follow the law, as well as the need to recognize the duty to provide service to taxpayers and exercise strong enforcement approaches only where warranted and on a fair basis.

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

C.2.8.1. Drawing upon the factors discussed above, the start-up phase of transfer pricing operations requires:

- A critical look at the availability of human resources within the tax administration. Prioritization is essential and choices have to be made concerning the attention to be given to different kinds of taxes. A policy on transfer pricing without sufficient resources being available to the tax administration implementing it “on the ground” will not achieve its objective;
- Definition of the country’s industrial characteristics. It will be useful to look for statistics on trading volumes and other indicators for cross-border transactions. In a start-up phase many countries focus on their main industries (such as mining, pharmaceuticals, telecommunications, breweries and automobiles), and usually on the larger players in the industry in particular;
- Good, professional relations with business. Acceptance and understanding of the policy will reduce compliance and collection costs. Meetings with all stakeholders will help in effectively building and improving transfer pricing policy and capability. This also means less non-compliance is likely to be due to honest misunderstandings of the regime’s requirements, and that there is more current intelligence on existing and emerging issues. This allows more focussed and efficient guidance and enforcement action;
- Understanding what other countries have done at a similar stage, what they are doing now and where that represents an evolution. This can include:
 - Inviting representatives from other countries with a history of transfer pricing to give their views and share their experiences;

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- Reciprocal placements with countries that offer useful experience and are willing to assist can be an excellent way to learn. It will be necessary to first prepare a clear plan of what knowledge is being sought, why the other country willing to host a visit is the right country to learn from, and the expected impact and flow-on effects; and
 - Seeking support from donors to arrange visits to such countries, with rigorous and strategic selection of participants, a strong work programme and an obligation to report on the outcomes and lessons learned. All this will help to ensure that a visit is not perceived, including by the other country or potential donors, as a “holiday” for participants. This can have important additional benefits in personnel management as those who are most open to learning new things and are judged likely to stay with the organization for some time and take transfer pricing technical or managerial leadership roles may be offered such exposure;
 - Exploring the training assistance available from international organizations including the United Nations, the OECD, the World Bank Group, the IMF, and regional organizations such as ATAF and CIAT.
- An ability to define, with policymakers and administrators involved in the process, the important areas of focus bearing in mind:
- The main characteristics of the country’s industries, e.g. manufacturers or distribution activities;
 - The main kinds of cases contained in the workload of the tax administration;
 - The main types of activities to start with in developing policies, recognizing the need for policy to be soundly based in reality; and
 - Practical case studies that can provide input for policymaking and a focus for discussing administration issues.

C.2.8.2. After starting the transfer pricing unit, areas of focus will evolve depending on factors including the stage of development of the transfer pricing policy and the administration. In the first years it is often considered helpful to focus on less complicated activities such as contract manufacturing, intragroup services etc. When a higher level of experience is reached, the focus will often shift to more complicated areas such as intangibles and business restructurings. The same journey has been undertaken by developed countries. However, this does not mean that particularly blatant examples of mis-pricing in these more complicated areas should not be addressed at an early stage.

C.2.8.3. Assessing Effectiveness and Fine Tuning

C.2.8.3.1. It is best to set up a system of monitoring based on a performance measurement framework that establishes key performance indicators and outputs. While it is important not to overload staff, who will undoubtedly be very stretched for time and resources, with too much paperwork, possible areas of monitoring (some by raw data, some by questionnaires and interviews) include:

- The time schedules involved in transfer pricing disputes;
- Yield from risk-based audits and the percentage of yielding audits;
- Adjustments in tax assessment;
- Ability to respond quickly to emerging issues—including measurable deterrent effects on taxpayer behaviours;

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- The number of Mutual Agreement Procedures (MAPs);
- 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.

C.2.8.3.2. As with any such measurement process, if data that is collected is not being used by management to assess progress the reasons should be considered, and the data requirements modified, or the use of the data improved. In other words, the process of review should itself be reviewed for effectiveness on a regular basis.

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

C.2.9.1. **Japan** started its transfer pricing administration with a small unit in the late 1980s. Once the National Tax Agency (NTA) identified the rapidly increasing needs for transfer pricing management it expanded a nationwide training course for international taxation step-by-step, now reaching approximately 100 trainees every year; and also reorganized and gradually expanded the national and regional examination division. Currently the headquarters has transfer pricing sections and the MAP office, while the four major regional bureaux have special divisions for transfer pricing (including two divisions specializing in APAs). Although some essential documentation concerning transfer pricing is required by statute to be translated into Japanese, transfer pricing specialists are generally equipped with sufficient language skills to conduct examinations of the original accounting books, documents etc. in English.

C.2.9.2. 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.

C.2.9.3. 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.

C.2.9.3.1. 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.

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C.2.9.3.2. The IRBM Multinational Tax Department came into existence with the introduction of transfer pricing regulations under Section 140A and Section 138C of the Income Tax Act 1967 which came into effect on 1 January 2009. In 2008, measures towards centralizing transfer pricing activities were proposed and eventually came into force on 1 March 2009 when the unit became separated from the Compliance Department into a full department of its own. The Multinational Tax Department, headed by a senior director, now reports directly to the Deputy Director General of Compliance. The department is still relatively small, as the intention behind the set-up is to build expertise in a small group who will later be dispersed to provide assistance and knowledge to other branches within IRBM. In general, the Department has four divisions as follows, with individual division directors:

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

C.2.9.3.3. 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.

C.2.9.3.4. In **Kenya**, whilst resourcing and skills challenges remain for Kenya Revenue Authority (KRA), active measures have been taken by the KRA to build capacity in its transfer pricing unit by equipping the unit with the enough experienced staff with required set of skills, capacity building through continuous training and re-tooling and maintaining staff motivation through recognition and promotions. through international training and exposure, retaining multi-skilled staff in the unit and continuous re-tooling. Transfer pricing unit in Kenya has a highly skilled transfer pricing teams with different specialists including lawyers, accountants, economists and business analysts to ensure an understanding of commercial operations.

C.2.9.3.5. Kenyan law requires taxpayers to keep records for a period of 5 years, it requires specified persons to keep and retain the records, books of account or documents prescribed in the schedule to the notice. Assessments cannot be issued for any period beyond five years unless there is fraud or tax evasion schemes.

C.2.9.3.6. The main challenge that Kenya has in determining arm's length profits been lack of domestic comparables. There are no databases containing Kenya specific, or for that matter, Africa specific, comparable data. As a result, both the tax administration and taxpayers rely on European databases to establish arm's length levels of profitability. Challenges have been experienced in making adjustments for geographical differences or country risks adjustments (for example, market, economic and political differences).

C.2.9.3.6. Building on the practice adopted in India and China, KRA is currently considering its approach to location savings, location specific advantages and market premiums within certain industries and those factors will be addressed when conducting audits.

C.2.9.3.7. Concluding, the arm's length principle presents several challenges in terms of application for a developing country like Kenya. The hypothesis required to approximate transactions between related parties to what would have transpired had they been independent can be difficult and as stated, finding reliable comparable and making comparability adjustments is easier said than done. However,

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Kenya has made tremendous progress on taxation of MNEs by consistent enhancement of its capacity to deal with transfer pricing risks, update of legislative framework and taxpayer sensitisation.

ANNEX C: C.3. - DOCUMENTATION

C.3. DOCUMENTATION

C.3.1. Introduction

C.3.1.1. Adequate transfer pricing documentation can serve several useful functions. Quality transfer pricing documentation will: (i) ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices for transactions between associated enterprises; (ii) provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment; and (iii) provide tax administrations with useful information in order to enable evaluation of a taxpayer's transfer pricing position upon audit, thereby contributing to the avoidance of disputes and to the timely resolution of any transfer pricing disputes that may arise.

C.3.1.2. The OECD/G20 BEPS Project created a more consistent and useful documentation standard for use by countries. Insofar as possible, countries should conform their transfer pricing documentation requirements to established international standards in order to limit compliance burdens imposed on taxpayers. When these international standards are followed, documentation will be characterized by (i) sufficient detail to demonstrate the taxpayer's compliance with the arm's length principle, and (ii) the timely delivery of such useful information to tax authorities, enabling them to assess tax risks and begin audit investigations in appropriate cases. A taxpayer should make reasonable efforts to reflect in its documentation an adequate transfer pricing analysis of its material transactions with associated enterprises in order to establish its good faith effort to apply the arm's length principle.

C.3.1.3. This chapter first summarizes recent developments regarding the establishment of international guidelines on transfer pricing documentation. It then provides a more in-depth discussion on several topical issues that developing countries will need to address in adapting the international standards to their own needs. The chapter provides practical guidance on transfer pricing documentation related issues.

C.3.2. International Guidelines on Transfer Pricing Documentation

C.3.2.1 OECD/G20 Transfer Pricing Documentation Standard

C.3.2.1.1. The OECD first published guidance on transfer pricing documentation in 1995, shortly after the first individual country rules on documentation were developed. The original OECD guidelines contained general principles but did not prescribe a list of specific items to be included in transfer pricing documentation. Over the ensuing 20 years, numerous countries adopted transfer pricing documentation rules and gained experience administering those rules. Several multinational bodies also sought to develop consistent transfer pricing documentation standards. Notwithstanding these efforts by multinational bodies to encourage consistency, the various country rules differ from one another in many ways, a fact which complicates taxpayer compliance with global documentation requirements. Accordingly, in 2015, in connection with the OECD/G20 BEPS Project, the OECD

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guidance on transfer pricing documentation was updated to establish a uniform documentation standard.²⁷

C.3.2.1.2. The OECD/G20 2015 (Final Report on Action 13) guidance sets out a standardized three-tiered approach to transfer pricing documentation. It suggests that documentation should include: (i) a master file containing general information about the MNE group relevant to all MNE group members; (ii) a local file referring specifically to material transactions of the MNE group members resident in the local jurisdiction and setting out the taxpayer's transfer pricing methodology for such material transactions; and (iii) a country-by-country report ("CbC Report") containing certain information relating to the global allocation among taxing jurisdictions of the MNE group's income and taxes paid, together with certain general indicators of the location of economic activity within the MNE group. The Final Report on Action 13 also includes agreed guidance on implementing the new documentation and reporting rules. The OECD work builds on earlier work of other bodies, particularly that of the EU.

C.3.2.1.3. **Master File.** The master file is intended to provide a high level overview of the MNE's global operations. The new OECD/G20 documentation standard calls for the following information to be included in the master file:

- A chart illustrating the MNE's legal and ownership structure and the geographical location of operating entities.
- A general description of the MNE's business including:
 - (a) Important drivers of business profit;
 - (b) A description (which may be in the form of a chart) of the supply chain for the group's five largest products and/or service offerings by turnover and any other products or services amounting to more than 5 per cent of group turnover;
 - (c) A list and brief description of important service arrangements between members of the MNE group, other than research and development (R&D) services, including a description of the principal locations providing important services and the transfer pricing policies for allocating service costs and determining prices for intragroup services;
 - (d) A description of the main geographic markets for the group's products and services referred to in (b), above;
 - (e) A brief written functional analysis describing the principal contributions to value creation by individual entities within the group; and
 - (f) A description of important business restructuring transactions, acquisitions and divestitures occurring during the fiscal year.
- A description of the MNE's intangibles, including:
 - (a) A general description of the MNE's overall strategy for the development, ownership and exploitation of intangibles, including location of principal R&D facilities and location of R&D management;
 - (b) a list of intangibles of the MNE group that are important for transfer pricing purposes and an indication of which entities own those intangibles;

²⁷ OECD (2015), *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
<http://dx.doi.org/10.1787/9789264241480-en> (hereafter "OECD/ G20 Final Documentation Report").

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- (c) A list of important agreements among identified associated enterprises related to intangibles, including cost contribution agreements, principal R&D service arrangements, and licence arrangements;
 - (d) a general description of the group's transfer pricing policies related to R&D and intangibles; and
 - (e) A general description of transfers of interests in intangibles among associated enterprises during the fiscal year, including the entities, countries and compensation involved.
- A description of the MNE's inter-company financial arrangements, including:
 - (a) A general description of how the group is financed, including important financing arrangements with unrelated lenders;
 - (b) The identification of any members of the MNE group that provide a central financing function for the group, including the country under whose laws each entity is organized and its place of effective management; and
 - (c) A general description of the MNE's transfer pricing policies related to financing arrangements between associated enterprises.
 - The MNE's annual consolidated financial statement for the fiscal year if otherwise prepared for financial reporting, regulatory, internal management, tax or other purposes.
 - A list and brief description of the MNE group's existing unilateral advance pricing agreements and other tax rulings relating to the allocation of income among countries.

C.3.2.1.4. **Local File.** The new OECD/G20 documentation standard suggests that the local file should contain the following information:

- A description of the entity or entities in the MNE Group that operate in the local country, including:
 - (a) A description of the management structure of the local entity, a local organization chart and a description of the individuals to whom local management reports and the country where their offices are located;
 - (b) A detailed description of the business and business strategy pursued by the local entity including a description of recent business restructurings or intangibles transfers in the present or previous year involving the local entity and an explanation of aspects affecting the local entity; and
 - (c) A description of key competitors of the local entity.
- Information related to material controlled transactions involving the local entity, including:
 - (a) A description of the transaction and the context in which it takes place;
 - (b) The amount of inter-company payments or receipts for each category of controlled transactions involving the local entity, broken down by tax jurisdiction of the foreign payor or recipient;
 - (c) Identification of the associated enterprises involved in each category of controlled transaction and how they are related;
 - (d) Copies of all material agreements concluded by the local entity;

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- (e) A detailed comparability and functional analysis of the taxpayer and the relevant associated enterprises with respect to each documented category of controlled transactions including changes from prior years;
 - (f) An indication of the most appropriate transfer pricing method with regard to the category of transaction and the reasons for selecting that method;
 - (g) An indication of which associated enterprise is selected as the tested party, if applicable, with an explanation of the reasons that enterprise is selected;
 - (h) A summary of the important assumptions made in applying the transfer pricing methodology;
 - (i) An explanation of the reasons for using a multi-year analysis if relevant;
 - (j) A list and description of selected comparable uncontrolled transactions, if any, and information on relevant financial indicators for independent enterprises used in the transfer pricing analysis including a description of the comparable search methodology and the source of the information;
 - (k) A description of any comparability adjustments performed;
 - (l) A description of the reasons for concluding that relevant transactions were priced on an arm's length basis based on the application of the selected transfer pricing method;
 - (m) A summary of the financial information used in applying the transfer pricing methodology; and
 - (n) A copy of existing unilateral and bilateral/multilateral APAs and other tax rulings to which the local tax jurisdiction is not a party and which are related to the controlled transactions being analysed.
- Relevant financial information, including:
- (a) Annual local entity financial accounts for the year concerned;
 - (b) Information and allocation schedules showing how the financial data used in the transfer pricing analysis may be tied to the annual financial statements; and
 - (c) Summary schedules of relevant financial data for comparables used in the analysis and the sources from which that information was derived.

C.3.2.1.5. CbC Report. The CbC Report is intended to provide a general overview of the allocation of the MNE's global income and taxes paid among countries. It is intended to be used for the purpose of assessing transfer pricing and other tax risks. The OECD/G20 BEPS guidance contains a template for the CbC Report. On the first page of the template, the MNE is required to report on a jurisdiction-by-jurisdiction basis for constituent entities resident in the relevant jurisdiction:

- Total revenue, broken down into unrelated party revenue and related party revenue;
- Profit (loss) before income tax;
- Income tax paid (on a cash basis);
- Income tax accrued for the current year;
- Stated capital;
- Accumulated earnings;
- Number of employees; and
- Tangible assets other than cash and cash equivalents.

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On the second page of the template, the MNE should report, on a jurisdiction-by-jurisdiction basis:

- Each constituent entity in the group that is resident in the jurisdiction;
- The jurisdiction of organization or incorporation for each constituent entity if different from the jurisdiction of residence; and
- The main business activities for each constituent entity of the MNE group.

C.3.2.1.6. In addition to prescribing standardized content for the master file, local file and the CbC Report, the OECD/G20 BEPS guidance addresses several important implementation issues.²⁸

- It is recommended in the Final Report on Action 13 that the master file and local file elements of the documentation package be implemented through local country legislation or administrative procedures, and that the master file and local file be filed directly by the taxpayer with the local tax administration in each relevant jurisdiction;
- It is recommended in the Final Report on Action 13 that the CbC Report be filed with the jurisdiction of the parent company of the MNE Group and shared by that country with other interested countries through automatic exchange of information under the Multinational Convention on Mutual Assistance in Tax Matters, under bilateral tax treaties, or under TIEAs. It is recognized, however, that backup local filing requirements may be necessary in situations where the country of the parent company does not adopt the CbC filing requirement or where other specified circumstances make it impossible for the local jurisdiction to gain access to the CbC Report through treaty exchange mechanisms. Accordingly, if developing countries are to have access to the CbC Report, they will need to either join the Multilateral Convention on Mutual Assistance in Tax Matters or develop an extensive set of bilateral tax treaties and/or TIEAs that provide a basis for automatic exchange of CbC Reports filed in parent company jurisdictions. Under either of these alternatives, countries should also develop mechanisms for enforcing backup local filing rules in situations where MNE group members operating in their jurisdictions may not have ready access to all of the global MNE data contained in the CbC Report to which the tax administrations are entitled. Model competent authority agreements have been drafted to implement the exchange of CbC Reports and numerous countries have already adopted the implementing agreement under the Multilateral Convention. It is expected that most countries will opt for joining the Multilateral Convention²⁹;
- It is recognized that important confidentiality concerns arise in connection with the CbC Report. Tax administrations should take all necessary steps to ensure that there is no public disclosure of confidential information contained in the CbC Report or other elements of the transfer pricing documentation package, including adopting appropriate legal measures to protect confidentiality. Protection of confidentiality is one of the principal reasons that countries agreed to use treaty exchange mechanisms as the primary sharing mechanism for the CbC Report;
- It is recognized that the CbC Report will be helpful for high level transfer pricing risk assessment purposes. It may also be used by tax administrations in evaluating other BEPS

²⁸ See OECD/G20 Final Documentation Report, Annex IV.

²⁹ The OECD guidance on CbC reporting that has been published since the completion of the BEPS Action 13 Report contains detailed suggestions on the filing of CbC Reports, the sharing of those reports between relevant countries, the necessity of maintaining the confidentiality of CbC Reports obtained through information exchange procedures, and the appropriate use to be made of the CbC Reports. This guidance is contained in the documents described in paragraphs C.2.2.1.7 and C.2.2.1.8.

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related risks and, where appropriate, for economic and statistical analysis. However, the information in the CbC Report should not be used as a substitute for a transfer pricing analysis of individual transactions and prices based on a functional analysis and a comparability analysis. The information in the CbC Report on its own does not constitute conclusive evidence that transfer prices are or are not appropriate. The CbC Report should not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income. Countries participating in the BEPS project commit that if such formulary apportionment adjustments are proposed based on CbC Report data, they will promptly concede the adjustment in any relevant competent authority proceeding. However, this does not imply that jurisdictions would be prevented from using the CbC Report data as a basis for making further enquiries into the MNE's transfer pricing arrangements or into other tax matters in the course of a tax audit;

- It is recommended that only MNE groups with annual consolidated revenue of at least EUR 750 million (or an equivalent amount stated in local currency using January 2015 exchange rates) be required to file the CbC Report;
- Jurisdictions should utilize the standard template set out in the Final Report on Action 13 for the CbC Report, not requiring either more or less information to be reported;
- It was agreed that all aspects of the CbC Report, including its content and its implementation by taxpayers and tax authorities, will be reviewed again in 2020 after some experience is gained in preparing and using the CbC Report. In early 2020 the OECD released a list of questions that will be examined in this review and requested information from interested persons regarding those questions;
- The OECD/G20 work has also included the issue of high level technology standards for the format of CbC Reports to facilitate the exchange of such reports.³⁰

C.3.2.1.7. Since the publication of the Final Report on Action 13, the OECD has, from time to time, published guidance on implementing the new CbC reporting regime. This Guidance is contained primarily in two useful publications. These are (i) *Country-by-Country Reporting: Handbook on Effective Implementation*, published in September 2017³¹ and (ii) *Guidance on the Implementation of Country-by-Country Reporting: BEPS Action 13*, published in December 2019.³² These documents provide detailed suggestions to countries adopting a CbC reporting requirement and to taxpayers seeking to comply with the requirement.

C.3.2.1.8. The guidance contained in these two documents addresses a variety of topics including transitional filing options for MNEs, notification requirements for MNE groups during the transitional phase, the consequences of non-compliance with the confidentiality, appropriate use, and consistency requirements by countries and taxpayers, appropriate implementation of local filing requirements, the treatment of partnerships, investment funds and other special entities, the aggregation of data within a particular country, the treatment of dividends for purposes of the CbC filing thresholds, and numerous other questions.

C.3.2.1.9. The documents also provide technical guidance for governments on steps that can be taken to implement and simplify the filing and exchange between governments of CbC Reports and provide

³⁰ OECD (2016), *Country-by-country Reporting XML Schema: User Guide for Tax Administrations and Taxpayers*.

³¹ OECD (2017), *Country-by-Country Reporting: Handbook on Effective Implementation*, OECD, Paris.
www.oecd.org/tax/beps/country-by-country-reporting-handbook-on-effective-implementation.pdf

³² OECD (2019), *Guidance on the Implementation of Country-by-Country Reporting – BEPS Action 13*, OECD, Paris.
www.oecd.org/tax/guidance-on-the-implementation-of-country-by-country-reporting-beps-action-13.pdf

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detailed suggestions for training of relevant government personnel on a multilateral basis. An important point contained in the implementing guidance is that the CbC regime is premised on the use of company accounting data and that accounting conventions used by taxpayers will therefore be followed in resolving most detailed reporting questions.

C.3.2.1.10. For developing countries, the implementation guidance contains useful instruction on complying with confidentiality requirements, reporting breaches of the rules on appropriate use of CbC Report data, the possibility of suspending exchange of CbC Reports following consultation where proper use requirements have been violated, the resolution of cases where adjustments are inappropriately based on CbC report data, the technology schema to be used in sharing and receiving CbC Reports through exchange of information processes, and other important topics related to the exchange of CbC Reports between country tax administrations.

C.3.2.2. Implementation of Global Documentation Standards in Developing Countries

C.3.2.2.1. The international guidelines above were designed by the countries involved in the BEPS Project for adoption by them in the context of their own transfer pricing legislation, priorities, capabilities and experience. It cannot automatically be assumed that these international guidelines should be adopted wholesale in every developing country. It is therefore important to examine these guidelines from the perspective of how they may work in practice in a developing country context, bearing in mind the administrative constraints that may exist in the tax administration and the MNE. In considering the international guidelines, however, all countries should also consider the great benefit of having consistent documentation rules from country to country to minimize transfer pricing compliance burdens.

C.3.2.2.2. Developing countries can assume that, in the future, MNE's will prepare the master file and that large MNE's will prepare the CbC Report. Requiring these documents to be delivered to the local tax administration in a developing country should therefore impose no marginal compliance burden on the MNE. The important question for developing countries, therefore, will likely be whether the local file envisioned by the OECD/G20 guidance should be adopted without modification in the local country.

C.3.2.2.3. The international standards are not self-executing. As noted above, local laws and/or administrative requirements must be adopted in each country to require local filing of the master file and local file. As many developing countries are engaged in a modernization process for their tax administrations, including in most cases significant investments in automation, countries can consider what new technologies are available in this regard to minimize compliance costs for both tax administrations and taxpayers.

C.3.2.2.4. Not all transactions that occur between associated enterprises are sufficiently material to require full documentation in the local file. Individual country transfer pricing documentation requirements based on the OECD/G20 guidance on the content of the local file should include specific materiality thresholds that take into account the size and the nature of the local economy, the importance of the MNE group in that economy, and the size and nature of local operating entities, as well as the overall size and nature of the MNE group. Measures of materiality may be considered in relative terms (e.g. transactions not exceeding a percentage of revenue or a percentage of cost measure) or in absolute amount terms (e.g. transactions not exceeding a certain fixed amount). Individual countries should establish their own objective materiality standards for local file purposes based on local conditions. As discussed in greater detail below, consideration should also be given to rules that exempt small or medium-sized enterprises from documentation requirements or that limit the extent of the documentation to be provided by such entities.

C.3.2.2.5. Similarly, in setting out local law requirements related to the master file, it should be recognized that taxpayers should use prudent business judgment in determining the appropriate level

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of detail for the information to be supplied. It should be kept in mind that the purpose of the master file is to provide tax administrations with a high-level overview of the MNE's global operations and policies. Information should be considered important if its omission would affect the reliability of the transfer pricing outcomes.

C.3.2.2.6. The CbC Report is likely to be delivered to the local jurisdiction of the MNE's parent company and to be forwarded to developing countries under treaty exchange mechanisms. However, as noted above, developing countries may need to adopt the Multilateral Convention on Mutual Assistance in Tax Matters or expand their networks of bilateral tax treaties and TIEAs in order to get access to the CbC Reports. The implementation materials in the Final Report on Action 13 contain model legislation and competent authority agreements that can be tailored to local country needs in adopting the CbC reporting requirement. Substantial detailed guidance on implementing the CbC reporting regime has been developed and published in the documents referenced in paragraphs C.3.2.1.7 and C.3.2.1.8., above, and should be considered by developing countries as they implement CbC reporting,

C.3.2.2.7. In considering the implementation of documentation rules, developing countries could decide to use a disclosure form as an alternative to the list of required documentation contained in the OECD/G20 description of the local file. If such a disclosure form is used as a substitute for the local file, it should strike a balance between taxpayer effort required and its usefulness for tax authorities to make a proper assessment. The form should only be completed in relation to inter-company transactions of significant size. See the discussion of materiality in paragraph C.3.2.2.4. above. Completing the form (supplemented by the master file and CbC Report otherwise prepared by the taxpayer) could be sufficient to comply with initial documentation requirements. Under this approach a full detailed transfer pricing report may need to be produced only upon request, rather than being produced with the tax return in every case. The compliance burden and compliance costs for MNEs may be reduced by utilizing such a form, without unduly compromising the information that is ultimately available to tax authorities. Forms used in Canada and Nigeria may be useful examples. If disclosure forms are to be used rather than the local file format, tax authorities may want to consider that, to the extent these disclosure forms can follow a consistent format (i.e. list the same information as that required in disclosure forms used by neighbouring countries where the taxpayer may conduct business activities), the taxpayer burden in preparing the forms might be reduced. This in turn may serve to help enhance taxpayer compliance.

C.3.3. Experiences of Multinational Enterprises with Existing International Guidelines on Documentation

C.3.3.1. The documentation compliance burden has increased significantly in the past twenty years with more and more countries introducing specific transfer pricing documentation requirements. In the year 2000, there were approximately 15 countries with specific transfer pricing documentation requirements, rising to almost 60 countries in 2012 with even more countries introducing new documentation rules since then. As noted, there is a risk that countries may introduce transfer pricing documentation requirements that differ significantly from country to country, resulting in a substantial increase in compliance costs for MNEs.

C.3.3.2. MNEs welcome initiatives to reduce the compliance burden and the related compliance costs by introducing standards of required information that are relevant for multiple countries. The above-mentioned international guidelines should help to harmonize rules so the preparation of documentation will not become a business in itself instead of a support to the MNE's business and global tax compliance.

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C.3.3.3. Currently a large number of transfer pricing reports are prepared annually just to satisfy local requirements, e.g. country-specific nuances, local language, annual searches and increasing focus on local comparables. As many businesses do not undergo major changes and/or restructuring every year the added value of an annual transfer pricing report may be open to question. It is recommended that transfer pricing documentation be periodically reviewed in order to determine whether functional and economic analyses are still accurate and relevant and to confirm the validity of the applied transfer pricing methodology. In general, the master file, the local file, and the country-by-country report should be reviewed and updated annually. It is recognized, however, that in many situations business descriptions, functional analyses and descriptions of comparables may not change significantly from year to year. In order to simplify compliance burdens on taxpayers the tax administration may determine, as long as operating conditions remain unchanged, that the searches in databases for comparables supporting part of the local file be updated every three years rather than annually. Financial data for the comparables should nonetheless be updated every year in order to apply the arm's length principle reliably. See the Final Report on Action 13, paragraphs D.5.37 and D.5.38.

C.3.3.4. If more consistency can be achieved with regard to the information required, MNEs may develop a system that retrieves (part of) this information automatically from their financial information systems, ultimately reducing their compliance costs significantly.

C.3.3.5. It is important that the documentation rules be broad enough to capture the reality of the related party transactions without being excessively burdensome on the mere chance that, though unlikely, a particular piece of information may be relevant.

C.3.4. Practical Guidance on Documentation Rules and Procedures

C.3.4.1. Burden of Proof

C.3.4.1.1. In a number of countries the tax administration bears the burden of proof with respect to tax assessments unless a tax law specifically provides otherwise. Generally, that means that taxpayers need not prove the correctness of their transfer pricing unless the tax administration challenges taxpayers with concrete and clear reasons for such challenges. For further information consult Chapter C.1.

C.3.4.1.2. However, if a country has a set of specific documentation rules in its tax law or regulations, it may be the case that the burden of proof for the transfer price at which a taxpayer transfers goods or services with related parties falls on the taxpayer, unless the taxpayer is believed to have fulfilled the obligations imposed by such documentation rules. Even where the burden of proof rests on the tax administration, the tax administration might require the taxpayer to provide documentation about its transfer pricing, because without adequate documentation, the tax administration cannot assess the case properly. In some countries, where the taxpayer does not provide adequate documentation, there may be a shifting of the burden of proof in the manner of a rebuttable presumption in favour of the adjustment proposed by the tax administration.

C.3.4.1.3. In countries where the burden of proof generally lies with the taxpayer, the burden of proof may shift to the tax administration if a taxpayer presents to the tax administration (or a court) a reasonable argument and evidence to suggest that the transfer pricing was at arm's length. Further, in some countries with specific documentation rules, the burden of proof shifts to the tax administration if a taxpayer has reasonably complied with the documentation rules.

C.3.4.1.4. Developing countries should ensure that the relationships between documentation rules and the burden of proof are clear in their domestic law. The burden of proof should not be misused by the tax administration or taxpayers as a justification for making assertions that may be difficult to

substantiate through an ordinary level of transfer pricing documentation. In other words, both the tax administration and the taxpayer should practice good faith through reasonable documentation that their determinations on transfer pricing are consistent with the arm's length principle regardless of where the burden of proof lies.

C.3.4.2. Time frame to Produce Transfer Pricing Documentation

C.3.4.2.1. Countries have different timing requirements for the production of transfer pricing documentation. Any requirement that requires preparation of documentation at the time of the transaction, at the time the tax return is filed, or at the beginning of an audit may be referred to as a “contemporaneous” documentation requirement. Because timing rules differ from country to country, however, the Committee refrained from using the word “contemporaneous” to describe documentation requirements in this chapter in order to avoid confusion. Countries should consider what timing requirements best suit their needs and are consistent with their administrative procedures. Types of documentation requirements in use around the world may involve one or more of the following:

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

C.3.4.2.2. Taxpayers, in some cases, establish transfer pricing documentation to demonstrate that they have made reasonable efforts to comply with the arm's length principle at the time their intragroup transactions were undertaken based on information that was reasonably available to them at that point (hereinafter referred to as the “arm's length price-setting” approach). Such information includes not only information on comparable transactions from previous years, but also information on economic and market changes that may have occurred between those previous years and the year of the controlled transaction. In many countries, however, taxpayers are required to test the actual outcome of their controlled transactions to demonstrate that the conditions of these transactions were consistent with the arm's length principle, hereinafter called “the arm's length outcome-testing” approach. Such tests typically take place as part of the process for establishing the tax return at the end of a tax year. See Chapter B.2., paragraph B.2.4. for a detailed discussion of this area. See also OECD TPG, paragraphs 3.69–3.71.

C.3.4.2.3. A country that wishes to establish a transfer pricing documentation rule should take into account the existence of the two pricing approaches mentioned above. Whether the arm's length price-setting or outcome-testing approach is used, data for external comparables may not be readily available at the time of the analysis.

C.3.4.2.4. The OECD/G20 documentation standards do not mandate specific rules regarding the time at which documentation should be prepared or presented to the tax authorities.³³ The guidance

³³ Ultimately issues regarding the storage of relevant documents may depend on domestic law. Most countries may require taxpayers to keep documentation in paper format. However, depending on the development status of a country's electronic technology, some countries may require the taxpayer to store the material in a searchable electronic format instead of paper format. For example, the Republic of Korea provides in Article 85-3 of the

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contained in the Final Report on Action 13 suggests that the CbC Report be completed one year from the close of the MNE group's fiscal year to which the CbC Report relates.

C.3.4.2.5. The OECD Transfer Pricing Guidelines note that it would be quite burdensome if detailed documentation were required on all cross-border transactions between associated enterprises and by all enterprises engaging in such transactions. Therefore, it would be unreasonable to require the taxpayer to submit documents with the tax return specifically demonstrating the appropriateness of all transfer price determinations. The local file, in particular, should be limited to material transactions. As noted above, under the OECD/G20 guidance, the definition of materiality is left to local law and should be specified in light of local conditions.

C.3.4.3. Penalties

C.3.4.3.1. A country that requires its taxpayers to prepare transfer pricing documentation may operate a penalty system to ensure proper compliance with its documentation requirements. Penalties in relation to the transfer pricing regime can be generally divided into two groups based on the reason for imposing them: (i) penalties for underpayment of tax that is due; and (ii) penalties for non-compliance with documentation requirements.

C.3.4.3.2. However, a number of countries also have incentive measures eliminating penalties for underpayment of taxes in cases where obligations for proper documentation have been fulfilled by taxpayers even in cases where the amount of taxable income turns out to be increased as a result of a tax audit. The principle governing these incentive measures is often referred to as the “no-fault, no-penalty principle”.

C.3.4.3.3. In general, penalties can entail civil (or administrative) or criminal sanctions. Penalties imposed for failure to meet transfer pricing documentation requirements are usually monetary sanctions of a civil or administrative, rather than a criminal, nature. In some countries, a failure of the taxpayer to comply with documentation rules may lead to greater scrutiny by the tax administration and risk assessment and adjustments based on other information available to the tax administration or on the basis of other transfer pricing methods. These cases are more closely scrutinized, and can equally be seen as giving rise to greater risks of non-compliance.

C.3.4.3.4. It would be unfair to impose sizeable penalties on taxpayers that exert reasonable efforts in good faith to undertake a sound transfer pricing analysis to ascertain arm's length pricing, even if they do not fully satisfy documentation requirements. In particular, it would be unproductive to impose penalties on taxpayers for failing to submit data to which the MNE group did not have access at the time of the documentation process, or for failure to apply a transfer pricing method that would have required the use of data unavailable to the MNE group. However, this does not mean that a transfer price cannot be adjusted retroactively, with interest accruing on that amount.

C.3.4.3.5. Some countries consider that a penalty imposed due to a lack of proper documentation can be addressed through the Mutual Agreement Procedure between competent authorities under an applicable tax treaty, as it relates to the taxes to which the relevant treaty applies. Other countries consider that the issue of penalties, especially in relation to documentation, is distinct from the adjustments made and also from the issue of whether taxes have been imposed in accordance with the relevant tax treaty.

National Basic Tax Act (NBTA) that taxpayers shall faithfully prepare and keep books and relevant documents relating to all transactions until the expiry of the statute of limitation. However, according to the NBTA, taxpayers are also allowed to prepare the above-mentioned books and the relevant documents through an electronic system, and, in this case, they are required to keep that information on a magnetic tape, disk or any other electronic storage. See OECD TPG, paragraphs 5.35-5.36.

C.3.4.3.6. However, even where such a penalty is not covered by a tax treaty's Mutual Agreement Procedure, the penalty should not be applied in a manner that would severely discourage or invalidate a taxpayers' reasonable reliance on the benefits of the tax treaty. This includes the right to initiate the Mutual Agreement Procedure as provided in the relevant tax treaty.

C.3.4.3.7. For example, a country's requirements concerning the payment of an outstanding penalty should not be more onerous to taxpayers in the context of the Mutual Agreement Procedure than they would be in the context of a domestic law review initiated by the taxpayer.

C.3.4.4. Special Considerations for Small and Medium-sized Enterprises

C.3.4.4.1. Comprehensive documentation requirements and related penalties imposed on non-compliant taxpayers in a country may place a significant burden on taxpayers, especially on small and medium-sized enterprises (SMEs) or enterprises which engage in only limited cross-border transactions with overseas related parties. A number of countries have, therefore, introduced certain special considerations for SMEs in their transfer pricing documentation rules³⁴ Countries that have adopted special considerations for transfer pricing documentation in the case of SMEs include Brazil, China, Germany, India, Korea, Mexico, Nigeria, The Netherlands, Poland, Portugal, and others. The OECD/G20 BEPS guidance on documentation exempts MNEs with global revenues of less than EUR 750 million from the obligation to file the CbC Report, but rules as to whether SMEs should prepare the local file and master file are left to local law.

C.3.4.4.2. The accommodations made vary from country to country but may include an exemption from documentation obligations for smaller companies or for companies that engage in only limited cross-border business, a delay in the time the documentation must be prepared and submitted until transfer pricing issues are raised on audit, or a reduction in the level of detail required to be submitted by smaller businesses. These accommodations can be incorporated in legislation or adopted through administrative practice.

C.3.4.5. Language to be Used for Transfer Pricing Documentation

C.3.4.5.1. The Final Report on Action 13 notes that a requirement to provide transfer pricing documentation in the local language can constitute a complicating factor for transfer pricing compliance since both time and cost may be involved in translating documents. The language in which transfer pricing documentation should be submitted should be established under local laws. Countries are encouraged in the Final Report on Action 13 to permit filing of transfer pricing documentation in commonly used languages where it will not compromise the usefulness of the documents. Where tax administrations believe that translation of documents is necessary they should make specific requests for translation. Where translation is required, the tax administration should allow sufficient time to make such translations to limit the compliance burden.

C.3.4.5.2. Many countries require taxpayers to present transfer pricing documentation in the (country's) local language and require translation if the documentation was prepared in a different language. The Egyptian transfer pricing guidelines provide that if documents are provided in any language other than in Arabic, the taxpayer may be required to bear the cost of an official translation.³⁵ However, some countries such as France, Germany, the Netherlands and the Republic of Korea allow

³⁴ See, for example, the analysis of existing transfer pricing simplification measures undertaken by the OECD available from <http://www.oecd.org/tax/transfer-pricing/50517144.pdf>.

³⁵ Further information available from http://www.us.kpmg.com/microsite/taxnewsflash/tp/2011/TNFTP11_02Egypt.html.

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presentation of documentation in a language other than their own languages at least on an exceptional basis. It is particularly common to allow documentation to be provided in English.

ANNEX C : C.4. - RISK ASSESSMENT

C.4. RISK ASSESSMENT

C.4.1. Introduction

C.4.1.1. This section and the two that follow it discuss aspects of the enforcement of transfer pricing rules by the tax administration. This section (C.4.) principally discusses the transfer pricing risk assessment usually performed by the tax administration at the beginning of an audit. Section C.3. discusses aspects of the transfer pricing audit itself. Section C.6. discusses the resolution of transfer pricing disputes.

C.4.1.2. An effective enforcement process seeks to achieve two important outcomes:

- To enhance and incentivize future compliance (which indirectly contributes to future tax revenue and protection of the tax base); and
- To increase current tax revenues through appropriate adjustments to the income reported by taxpayers when such adjustments are called for.

These objectives will be achieved only if the audit and dispute resolution process is managed successfully.

C.4.1.3. Transfer pricing audits are generally time and resource intensive. The hard work involved in a transfer pricing audit may result in the collection of significant tax revenue that can benefit a developing country. However, such results do not come quickly and easily.

C.4.1.4. The success of an audit often depends on the preparation and planning that take place in the first stages of the audit, especially in the risk assessment phase. Tax administrations do not have the resources to audit every cross border transaction or every taxpayer. Accurate risk assessment enables informed case selection, which in turn helps the tax administration avoid wasting its enforcement resources. It is therefore important to dedicate adequate time and resources to risk assessment.

C.4.1.5. Risk assessment should be the first step of an audit and should continue through the various stages of the audit. Risk assessment involves an ongoing cost/benefit analysis, which helps to ensure the most efficient and effective use of tax administration time and resources and helps to ensure that taxpayers are not unnecessarily inconvenienced when their compliance with the transfer pricing rules is evident. Risk assessment must be built into the auditing process and incorporated into an audit programme.

C.4.1.6. The OECD has recently published a very useful handbook on transfer pricing risk assessment.³⁶ 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.

³⁶ OECD, Country-by-Country Reporting Handbook on Effective Tax Risk Assessment (2017)
<http://www.oecd.org/tax/beps/country-by-country-reporting-handbook-on-effective-tax-risk-assessment.pdf>

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

C.4.2.1. Overview

C.4.2.1.1. Effective risk identification and assessment are important steps toward ensuring that the most appropriate cases are selected for audit. Given the resource constraints of tax administrations it is important for any tax administration that high risk transfer pricing cases do not “slip through the tax net”. However, even the most robust risk identification and assessment tools and processes may not always guarantee success in audit. The reason for this is that the level of detail contained in information available to the tax administration at the risk assessment stage may not always be sufficient to draw reliable conclusions regarding the arm’s length nature of profits/prices. A determination of whether the prices utilized by the taxpayer are in fact arm’s length will depend on a full functional analysis (based on the risks assumed, functions performed, and risks borne by each party), the transfer pricing methods applied, allocation keys selected and so forth. The risk assessment does not involve a full functional analysis. It is instead intended to identify whether such a full analysis is warranted given the constraints on tax administration resources.

C.4.2.1.2. There are several ways in which a tax administration may conduct its risk identification and assessment, and the approach taken is largely dependent upon the type of information and data that is available and accessible. For example, exchange control authorities in some countries may work hand in hand with the tax administration enabling strong sharing of information between them while in other countries such interaction may be prohibited. Some countries have strong filing and documentation requirements designed to ensure that relevant and appropriate information is submitted. The new global documentation standard described in section C.4., will provide most tax administrations with information useful in assessing transfer pricing risk.

C.4.2.1.3. It is important to draw a distinction here between the information related to filing a tax return and that contained in transfer pricing documentation. This may vary from country to country but in essence is as follows:

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

C.4.2.1.4. The OECD BEPS Action 13 *Country-by-Country Reporting: Handbook on Effective Tax Risk Assessment* published in September 2017³⁷ provides detailed guidance on how the information provided under the documentation standard, and especially in the CbC report, can be used by tax administrations in conducting risk assessments.

C.4.2.1.5. A risk identification and assessment process followed by engagement with the taxpayer can be a worthwhile approach for tax administrations to adopt. This allows for better understanding of the risks identified and gives taxpayers the opportunity to explain the commercial context of the transactions/risks identified. Such an approach is designed to ensure that the risks have been profiled in the most robust manner before resources are committed to carrying out an in-depth audit.

³⁷ OECD (2017), *Country-by-Country Reporting: Handbook on Effective Tax Risk Assessment*, OECD, Paris. www.oecd.org/tax/beps/country-by-country-reporting-handbook-on-effective-tax-risk-assessment.pdf

C.4.3.2. Categories of Risk

C.4.3.2.1. Intragroup transactions, e.g. payments for goods, services and intangible property, provision of financial assistance, etc., give rise to transfer pricing risk. Such transactions or categories of transactions are often readily identifiable on the income statement and/or tax return or from required transfer pricing documentation.

C.4.3.2.2. It may be useful to try to place the transfer pricing risks into categories in order to give added value and context to the risk identification and assessment process. Such categorization can assist risk profilers/assessors to evaluate the aggressiveness of taxpayer positions and the complexity of the risk, the possible amount of tax at stake, and the probability of generating significant tax revenue through audit. Such classification can assist in determining whether a case is worth pursuing and whether or not the requisite resources and expertise are available.

C.4.3.2.3. Some of the types of transfer pricing risk that may be considered in a risk assessment include:

- Category 1: Profit shifting through new transactions or structures;
- Category 2: Profit shifting through restructuring of business operations;
- Category 3: Other types of intentional profit shifting such as through incorrect functional classification, the use of incorrect methods, allocation keys etc.;
- Category 4: Issues involving “thick” or “thin” capitalization; and
- Category 5: Unintentional profit shifting.

C.4.3.2.4. The examples of risk categorization provided in the previous paragraph can assist the risk profiler/assessor in the evaluation of each of the following factors:

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

Category 1: Profit shifting through new transactions or structures

C.4.3.2.5. This category includes new transactions and business structures implemented by multinationals with the intention of saving taxes by shifting profits. It is assumed that the potential tax savings for groups implementing these types of transactions or structures may be significant and the tax risk is therefore assumed to be high.

C.4.3.2.6. Important changes in corporate structure must now be disclosed in transfer pricing documentation (see chapter/(section?) C.3.). A tax administration’s awareness of possible tax planning schemes and structures and its own analysis of potential loopholes in the tax system may help identify useful lines of audit inquiry.

Category 2: Profit shifting through restructuring of business operations

C.4.3.2.7. 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.

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C.4.3.2.8. 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 restrict

C.4.3.2.9. 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

C.4.3.2.10. 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) profit 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.

C.4.3.2.11. It may be a challenge for a revenue authority to detect the types of intentional profit shifting activity by an MNE dealt with in Category 3. It would for instance require an evaluation of profit margins over an extended period of time against market/industry trends, an in-depth functional analysis of the entities that are party to the transactions and a detailed understanding of the pricing policies. The CbC report may be useful in supporting this type of analysis.

Category 4: Issues involving thin or thick capitalization

C.4.3.2.12. This category of risk includes both intentional and unintentional profit shifting by MNEs using intercompany debt and capital. In most countries, thin capitalization is regulated through safe harbours set at predetermined levels of debt to equity. Where this is the case, the likelihood for risk profilers/assessors of spotting such abuse is high, as these calculations can be easily performed or even automated to flag thinly capitalized entities. Even in cases where countries do not have safe harbours, they can set parameters or thresholds for risk assessment purposes. Risks related to over-capitalisation may be harder to identify and challenge as bright line tests related to excessive capital most often do not exist.

C.4.3.2.13. The local laws and regulations will influence the level and amount of resources required to audit these cases. Values can range from very low to very high, but their quantification should be simple (in cases where safe harbours or risk assessment thresholds exist). This should be an area of focus for developing countries with simple thin capitalization rules as it could be considered what is often termed “low hanging fruit”—meaning that audit action in such a case may be quickly and easily rewarded by identifying amounts of tax that should be paid.

Category 5: Unintentional profit shifting

C.4.3.2.14. 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 or other factors.

C.4.3.2.15. Where this occurs it is possible that the values could be material. The level and quantum of resources required to audit the case would depend on the nature and extent of the perceived transgression by the taxpayer.

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C.4.3.2.16. The following table summarizes some of the types of transfer pricing risk that can be identified in a transfer pricing risk assessment. These factors may suggest the need for additional audit investigation.

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

		Use of offshore branches in low-tax jurisdictions with double taxation treaties
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C.4.3.3. Possible Approaches in Risk Assessments

C.4.3.3.1. 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

C.4.3.3.2. 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 could include, for example, interest-free loans and thin capitalization. Some transactions are more easily identifiable but not necessarily easily audited in all circumstances. Restrictions on access to information in a particular jurisdiction may limit the kinds of transactions that may be easily audited.

C.4.3.3.3. 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

C.4.3.3.4. A revenue authority may adopt an approach under which transactions entered into with entities located in specified 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.

C.4.3.3.5. 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

C.4.3.3.6. This is in essence a hybrid of the transactional and jurisdictional approaches, but could also consider factors other than the jurisdiction of the related party or parties and the type of transactions.

C.4.3.3.7. 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 the company/group generally is with transfer pricing requirements in that country or elsewhere in the world. Where groups/entities have been successfully investigated by other revenue authorities this could provide an indication that the group presents a higher risk for transfer pricing purposes;
- A group that has recently undergone a business restructuring, particularly where the local entity has been “stripped” of certain risks and/or functions as part of the restructuring; and
- Companies with excessive and/or continued accounting or tax losses relative to a profitable group outside the country where the risk is being assessed.

C.4.3.4. Sources of Information for Risk Assessment

C.4.3.4.1. 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.4.

C.4.3.4.2. 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.

C.4.3.4.3. 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.

C.4.3.4.4. Particular attention should be paid to any notes to the financial statements on related party transactions and loans/financial assistance.

C.4.3.4.5. 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.

C.4.3.4.6. As noted above, information from the taxpayer's transfer pricing documentation can be very useful.

C.4.3.5. Risk Factors

C.4.3.5.1. Certain risk factors or "flags" can point to the need for further examination. However, such factors should not be treated as decisive in determining that non-arm's length pricing has occurred. Instead, these factors point to a higher than normal likelihood of such mis-pricing and suggest that further audit review is warranted. Identified risk factors may include:

- Consistent and continued losses;
- Transactions with related parties in countries with lower effective/marginal tax rates, especially "secrecy jurisdictions" from which tax information is not likely to be shared;
- Local low profit or loss making companies having material cross-border transactions with related parties offshore, where the offshore part of the group is relatively much more profitable;
- The existence of centralized supply chain companies in favourable tax jurisdictions, i.e. centralized sourcing or marketing companies located in jurisdictions with low-tax or no-tax regimes and which are not located in the same country/region as the group's main customers and/or suppliers;
- A poor tax compliance history;
- Lack of documentation to support transfer prices;
- Significant inconsistencies between profits of an individual group entity and the 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 (see para 31 above). This also 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;
- Material commercial relationships with companies in jurisdictions that employ safe harbours or similar rules that do not always align with the arm's length principle.

C.4.3.6. The Risk Assessment Process

C.4.3.6.1. As stated, the risk identification and assessment process may vary from one tax administration to another depending on the approach taken, the resource capability, and the stage at which potential challenges are considered. Some tax administrations have very sophisticated processes employing computerized systems and computational analyses, while others may adopt a more simplified process. Ultimately the risk identification and assessment process will depend on what a tax administration has at its disposal in terms of information, capability and systems or technology. It can, however, be said that the more refined and sophisticated the risk identification and assessment process, the easier it will be to ensure that high risk transactions are identified and audited in a timely manner.

C.4.3.6.2. 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 in para 6. contains detailed suggestions as to how the risk assessment process may be carried out.

C.4.3.7. Risk Assessment Tools

C.4.3.7.1. 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 tax inspectors and on transfer pricing documentation. This may include, for example, information available from the tax returns and audited financial statements to assist tax inspectors in identifying (or “flagging”) those cases with probable transfer pricing/thin capitalization risks.

C.4.3.7.2. Where specialist transfer pricing capability and resources are limited, generalist tax inspectors/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.

C.4.3.7.3. Basic quantitative risk assessment tools are particularly effective in the identification of thin capitalization risks as this usually involves a quantitative test of the financial data and is in most cases, depending on the local legislation, a matter of objective fact rather than more subjective

opinion. Automated risk assessment tools that can be used to run through large sets of available data can be used very effectively in this area.

C.4.3.8. Risk Assessment Findings

C.4.3.8.1. It is important that the outcomes of a risk identification and assessment process be documented and signed off for governance and control purposes and preferably saved in a central repository, i.e. a database of cases assessed, whether or not leading to a detailed audit or to tax assessment.

C.4.3.8.2. 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.;
- The outcome of the risk identification and assessment process, i.e. what was recommended and why; and
- Specific issues and transactions identified for further audit.

ANNEX C : C.5. - TRANSFER PRICING AUDITS

C.5. Transfer Pricing Audits

C.5.1. Planning for a Transfer Pricing Examination

C.5.1.1. If a determination is made at the conclusion of the risk assessment (discussed in chapter/section C.4.) 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.

Formation of the Examination Team

C.5.1.2 Where the transfer pricing unit of the tax administration decides to examine transfer pricing, the examination team should ideally be comprised of:

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

C.5.1.3. 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 and the staffing constraints of the tax administration. One person may be able to effectively perform two or more of the above functions. The skill groups identified above illustrate the knowledge and expertise needed for a transfer pricing audit team.

C.5.1.4. 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.

C.5.1.5. 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;

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

C.5.1.6. 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 the preparation of the case for possible litigation more effective.

Supervision of Examination

C.5.1.7. 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.

C.5.1.8. When Japan enacted its transfer pricing 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.

C.5.1.9. 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.

Issues for Examination/Examination Plan

C.5.1.10. It is necessary to decide what issues will be investigated in a transfer pricing examination.³⁸ This will be based on the risk assessment and involves the establishment of a transfer pricing examination plan.

³⁸ 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.

Audit Timetable

C.5.1.11. A transfer pricing audit usually takes longer than an ordinary tax audit because the scope of the factual matters to be investigated is much broader and the amount of time and effort needed for transfer pricing analysis is much greater. In general, the time needed would be an average of one to two years. Experience has shown that examinations rarely proceed in accordance with the timetables set forth in the examination plan. The main reason is that the progress of an examination depends on whether the information requirements set forth in the examination plan are satisfied. Unfortunately, the required information is not always obtained on time. It may be necessary to check the progress of the audit periodically to reconsider the audit timetable and the extent of information needed by the audit team.

Statute of Limitations as Provided for in the Domestic Law

C.5.1.12. 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.

C.5.1.13. Another aspect of the statute of limitations period is its permanence i.e. whether it is fixed or the taxpayer can waive the benefit accorded. For example, in the United States a taxpayer can waive the benefit of the statute of limitations but in other countries including Japan the statute of limitations period is fixed and the benefit cannot be waived by a taxpayer.

Approvals and Sign-off

C.5.1.14. Once a transfer pricing audit has started, it 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 tax administration's committee on transfer pricing audits before the examination starts from the viewpoint of effective use of the tax administration's human and other resources.

C.5.2. Preliminary Examination

Desk Audit

C.5.2.1. Normally, the tax authorities have certain transfer pricing information in their possession before a transfer pricing audit starts (see paragraph C.5.2.5.3.). A desk audit of such information, especially financial statements, should be made to evaluate whether there are any transfer pricing issues. For instance, computing the following financial ratios based on tax and financial data may be useful:

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

C.5.2.2. 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

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indicate a transfer pricing problem. The findings from the desk audit should be analysed to determine what further action, if any, is needed.

Understanding the Taxpayers' Business

C.5.2.3. 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 the taxpayer's 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.

C.5.2.4. The following may be useful sources for gaining an understanding of the taxpayer's business operations:

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

C.5.2.5. The following questions are among those which may be asked in order to understand the taxpayer's operations:

- 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?

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- 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 carry out advertising activities?
- Which members of the controlled group created the sales tools?; and
- Which members of the controlled group created and maintained the list of customers?
- If the taxpayer is engaged in the *manufacturing* of products:
 - Are affiliates distributing or selling the same or similar products to those the taxpayer manufactures?
 - Is the taxpayer using the same or similar manufacturing intangibles to those its affiliates are using?
 - What patents and/or know-how are involved in the relevant technology?
 - Is there a cost sharing agreement?
 - Did affiliates or the taxpayer buy into a cost sharing agreement?
 - What research and development is conducted?
 - What members of the controlled group do research and development?; and
 - How are the results of research and development disseminated among members of the controlled group?

C.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.

Understanding the Industry in which the Taxpayer Operates

C.5.2.7. The following procedures may be used in order to understand the taxpayer's industry:

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

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- Comparing the competitors' activities with those of the taxpayer; and
- Comparing the competitors' financial data with those of the taxpayer.

Approval

C.5.2.8. 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.

C.5.2.9. The approval process will need to be coordinated with the organizational model of the transfer pricing administration. See Chapter C.2.

C.5.3. Audit Procedure

Audit Approach

C.5.3.1. 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.

Notification to Taxpayer

C.5.3.2. 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.

C.5.3.3. 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. For example, if the statute of limitations is six years, the taxable years to be covered may be as many as five or six years.

C.5.3.4. 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.

Gathering of Information

C.5.3.5. 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.

C.5.3.6. 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

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together with the tax returns and constitute important financial documents for the transfer pricing audit;

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

C.5.3.7. 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.

C.5.3.8. 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 many 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 usually has no obligation to create a document for tax examiners. Further, it is often necessary in a transfer pricing audit for the taxpayer to explain its business operations. Taxpayers are expected to cooperate with the audit team in providing the necessary data and explanations, and a cooperative atmosphere during transfer pricing audits is desirable and to be encouraged.

C.5.3.9. The principal means for the audit team to collect the necessary information is the written information request. The information request is usually backed up by civil or criminal 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.

C.5.3.10. 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, for example, 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.

C.5.3.11. 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.

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C.5.3.12. It may be useful to interview the personnel of the taxpayer engaged in marketing and sales and those in the accounting and financial departments. 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.

C.5.3.13. 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 securities 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.

Sources of Information

C.5.3.14. As noted above, 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.

C.5.3.15. 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.

C.5.3.16. 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.³⁹ 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.

Language

C.5.3.17. 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.

C.5.3.18. 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.

C.5.3.19. 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.

C.5.3.20. The English language may have a unique position as a foreign language in this context. In most non-English speaking countries tax examiners in charge of transfer pricing taxation are trained to understand English and may be able to read documents in English.

³⁹ Japanese Special Taxation Measures Law Art. 66–4, paragraph 8.

Types of Information to be Gathered

C.5.3.21. 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.

C.5.3.22. 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.

C.5.3.23. The taxpayer's financial statements provide basic financial information. However, the transfer pricing audit is often focused on the sales or purchases of particular products, the provision of particular services or the licensing of particular technology. It then becomes necessary to segment revenues, expenses, gross profit and/or operating profit. A segmentation of the profit and loss statement is thus often conducted, focusing on transactions under review by the tax auditors. The preparation of segmented profit and loss statements will require additional work by the taxpayer who knows the details of the profit and loss statements. The accurate review and assessment of the financial results will often be impossible without segmented profit and loss statements.

C.5.3.24. 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.

Points for Examination at the Initial Stage

C.5.3.25. 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.

C.5.3.26. 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:

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- Verification of whether or not the gross and operating profit margins of related transactions under the examination are within the range of the profit margins of uncontrolled transactions in the same business category and substantially similar to the related transactions in terms of quantity, market level and other respects; or
- Use of the average value of the consideration or profit margins for related transactions or transactions deemed comparable with the related transactions during a reasonable length of time before and after a taxable year under examination. This may be done if it is considered inappropriate to examine the price of inventory products and other aspects of the related transactions based only on the information for each relevant taxable year, due to considerable fluctuations in prices reflecting changes in public demand, product lifecycle or other such factors.

C.5.3.27. 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.

Contemporaneous Documentation

C.5.3.28. Contemporaneous documentation is explained in detail in Chapter C.3. 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.

C.5.3.29. 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.

Information Request/ Supplemental Information

C.5.3.30. The following is a sample list of information documents required from a corporation engaged in the distribution of products on the assumption that the taxable period under audit is five years. The requested information should be the most up to date unless otherwise required.

- Corporate profile brochure (including the corporate group's history);
- Organizational chart (setting out the number and names of employees);
- Transactional structure: a business flow chart (invoicing and settlement, and actual delivery flow);
- List of shops: location, size, opening times, sales revenue, staffing, prices, contractual terms with customers (consignment/cash sales etc.) including data on the latest three years for sales, revenue and staffing;
- List of directors;
- Equity relationship structure of group companies;
- Basic business agreements, distribution agreements and other agreements with the related party;
- Corporate profile of the related party;

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- Documents related to determination of arm's length price;
- Transfer pricing method and list of margins by categories of product for five years;
- Latest financial data regarding the sales, cost of goods sold, operating expenses, operating profits and profit before tax for past five years;
- Group global consolidated profit and loss statement and ratio of taxpayer's sales to group global sales for past five years;
- Segmented profit and loss statements from the related transactions of the related party (if the taxpayer is the purchaser) or the taxpayer (if the taxpayer is the seller) for past five years;
- List of gross and operating profits by category, by product and by distribution channel with detail of losses on disposal of assets and losses from obsolescence for the past five years; and
- Top 10 products in sales by category (name of product, purchase price and retail prices, personnel expenses, advertising expenses and sales promotion expenses) for the past five years.

C.5.3.31. 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.

Request for Interviews

C.5.3.32. 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.

C.5.3.33. 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.

C.5.3.34. The interviewees should be made familiar with the process and should understand the procedures, purpose and importance of the interview.

C.5.3.35. Interviews are usually conducted in a cooperative manner. The taxpayer may work with the examination team to agree the rules of the interview by an advance agreement, to avoid confusion. This advance agreement will make it less likely that the taxpayer's efforts will be interpreted as attempts to manipulate the information obtained at the interview. For example, the taxpayer may wish to arrange for the examination team to meet with a group of employees, rather than meet each person separately. In this way the employees have an opportunity to consider the responses of other individuals. On the other hand, the examination team may want to interview each person separately.

C.5.3.36. 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.

C.5.3.37. 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.

Request to Visit Facilities

C.5.3.38. 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.

Secret Comparables

C.5.3.39. 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.

C.5.3.40. 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.”

Attorney-Client Privilege and Work Product Doctrine

C.5.3.41. 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.

C.5.3.42. 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.

Comparison Chart

C.5.3.43. In the process of examination, it may be useful to prepare a comparison table of the tested party and the comparable. A simple example of a comparison table is shown below.

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Table C.5.3:

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.5.4. Narrowing of Issues: Development of Tax Authorities’ Position

Refining Understanding of the Taxpayer’s Business

C.5.4.1. 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.

Refining Understanding of the Taxpayer’s Industry

C.5.4.2. 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.

Refining Functional Analysis

C.5.4.3. 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.

C.5.4.4. The examiners will need to determine the effect of intangibles 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.

C.5.4.5. 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 step 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.

Choice of Transfer Pricing Method

C.5.4.6. 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.

Economist's Report or Examiners' Interim Opinion

C.5.4.7. Toward the end of the examination procedure, the examination team often produces a written economist's report or examiners' interim opinion; unless the examiners judge that no adjustment should be made. It is often helpful to resolve factual issues important to the analysis or agree to disagree on certain issues while the information is fresh rather than delaying the resolution until the end of the examination process. This will help to narrow the scope of any points of disagreement as much as possible.

C.5.4.8. The taxpayer has significant flexibility at this stage. It may refuse and disagree with the report or opinion, accept or suggest modifications.

Draft Proposed Adjustments

C.5.4.9. 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. In some countries, the proposed adjustments may be combined with the examiners' interim report described above, depending on the circumstances.

C.5.4.10. This will be the last chance for the taxpayer to determine whether or not to reach a settlement with the examination team.

Formal Notification to Taxpayer of Proposed Adjustment

C.5.4.11. Unless the taxpayer and the examination team can reach agreement, the formal notification of the proposed adjustment will be issued.

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C.5.4.12. 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.

Issuance of Adjustment/Correction

C.5.4.13. 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.

Settlement Opportunities

C.5.4.14. 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.

C.5.4.15. 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.6. of this Manual.

C.5.5. Case Closure

C.5.5.1. 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.

Table C.5.5: Audit Closure Template

AUDIT TEAM:		DATE:
TAXPAYER NAME:	TIN:	
	TAX PERIOD:	
PHYSICAL ADDRESS:	AUDIT TYPE:	
DATE OF COMMENCEMENT:	DATE OF COMPLETION:	

TAXPAYER’S NATURE OF BUSINESS & MAIN ACTIVITIES:

MEMBERS OF AUDIT TEAM			
NAME	DESIGNATION	EMPLOYEE ID. NO.	
1			

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2				
3				
4				
5				

TAX TYPES COVERED	TAX PERIODS AUDITED

1. AUDIT OBJECTIVE

2. AUDIT SCOPE

3. RISKS IDENTIFIED AT PROFILING AND PLANNING STAGE

4. RISKS IDENTIFIED DURING AUDIT EXECUTION

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5. RECORDS REVIEWED AND AUDIT METHODOLOGY USED (work done)	Cross reference to working papers
--	

6. AUDIT FINDINGS i.e. observations on compliance (accuracy, completeness and validity)	
--	
--	

7. SUMMARY OF REVISED ADJUSTMENTS/ASSESSMENTS AND TAX PAYABLE						
TAX TYPE	PERIOD AUDITED	REVISED TAX	PENALTY	INTEREST	TAX PAID	TAX DUE

7A. SUMMARY OF LOSSES CARRIED FORWARD/ UNABSORBED CAPITAL ALLOWANCES RELIEVED		
YEAR	LOSS C/F RELIEVED	UNABSORBED C/A RELIEVED
2011		
2012		
2013		
2014		
2015		
2016		

8. TAXPAYER'S BANK ACCOUNT(S) DETAILS

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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
Name, Signature and Date

13. OBSERVATIONS BY TEAM LEADER

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

C.5.6. Tax Audits and Dispute Resolution

C.5.6.1. Certain aspects of transfer pricing audits (and tax audits in general) are relevant in the context of dispute resolution. Understanding how tax audit practices, audit settlements and joint audits may be useful in avoiding and resolving tax disputes is crucial for tax administrations and taxpayers. These issues are discussed further in chapter C.6; which follows.

ANNEX C: C 6. - DISPUTE AVOIDANCE AND RESOLUTION

C.6. DISPUTE AVOIDANCE AND RESOLUTION

C.6.1. Introduction

C.6.1.1. Dispute avoidance and resolution procedures are essential to the effective and efficient functioning of all tax administrations. Such procedures, if properly designed and implemented, can enable fair and expeditious resolution of differences between tax administrations and taxpayers regarding interpretation and application of the relevant tax laws and treaties.

C.6.1.2. The goal of dispute avoidance and resolution procedures is to facilitate the efficient and equitable determination and collection of tax revenues that are properly due. Ideally, this determination and collection should be done in ways that minimize controversy, cost, uncertainty and delay for both tax administrations and taxpayers. The most efficient method of addressing disputes is to prevent them from arising. Tax administrations seeking to use their resources most efficiently should therefore probably focus in the first instance on procedures for avoiding disputes while subsequently ensuring that appropriate dispute resolution procedures are available, should they become necessary.

C.6.1.3. In the cross-border context, dispute avoidance and resolution procedures are particularly important to avoid double taxation of the same income for a taxpayer or for associated enterprises. These procedures can also help avoid the imposition of tax not in accordance with the provisions of the applicable tax treaty, if any. When a tax treaty applies both tax administrations involved in a tax dispute ought to give effect to the provisions of that tax treaty and ought to provide rules and procedures for departing from the domestic law result where necessary to resolve disputes in accordance with the relevant tax treaty provisions.

C.6.2. Special Considerations for Developing Countries

C.6.2.1. The number of Mutual Agreement Procedure (MAP) disputes worldwide has been rising rapidly according to the MAP data published by the OECD available at the OECD website.⁴⁰

⁴⁰ See <https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics.htm>.

The most recent report is Mutual Agreement Procedure Statistics for 2018

C.6.2.2. However, tax administrations often face resource limitations regarding the handling of (cross-border) tax disputes and such limitations may be even greater for the tax administrations of many developing countries. Such limitations may affect staffing levels, training budgets, access to commercial databases needed for transfer pricing analyses and other research materials, access to outside experts, travel funding and other factors. It should be recognized that such resource limitations may put tax administrations at a real (or perceived) disadvantage when dealing with better-resourced administrations. It is thus particularly important for developing countries that dispute avoidance and resolution procedures be designed to operate as efficiently as possible, to minimize the demand on tax administration resources. Efficient dispute avoidance and resolution procedures should benefit taxpayers as well. Access to properly functioning dispute avoidance and resolution procedures is particularly important for multinational enterprises as they are called on to comply with the tax laws and reporting requirements of many dozens of countries and may need to address any audits or disputes that may arise in any of the countries where they do business.

C.6.2.3. There are various administrative procedures that could be applied to minimize transfer pricing disputes and to help resolve such disputes when they arise between taxpayers and their administrations, and between different tax administrations. Where two or more tax administrations take different positions in determining arm's length conditions, double taxation may occur. This means that the same income is included in the taxable base by more than one tax administration. Double taxation is undesirable and should be eliminated wherever possible, because it constitutes a potential barrier to development of international trade and investment flows.

C.6.2.4. This chapter discusses several approaches to resolving disputes arising from transfer pricing adjustments and for avoiding double taxation. The respective procedures all call upon domestic tax administration resources. If resource mobilization is a key concern or limiting factor for a country's tax administration, it should consider the approaches that can be realistically made available, are appropriate, and the provision of the facilities investments that may be required to expand the available dispute resolution procedures.

C.6.3. Dispute Avoidance Procedures

C.6.3.1. Legislation and Guidance

C.6.3.1.1. As in other areas of law, clear guidance in advance regarding any legal transfer pricing requirements that apply can serve to reduce tax disputes. This is equally important both for tax administrations, which need such guidance to apply the law properly and equitably, and for taxpayers, which must comply with the law. Clear guidance can help avoid unexpected results and therefore help minimize controversy.

C.6.3.1.2. Guidance can serve these purposes only if it is clear and detailed enough to be properly understood by both tax administrations and taxpayers. Countries that have adopted transfer pricing legislation have to strike various balances between the provision of general principles and detailed rules in that legislation and accompanying guidance. Where general principles are preferred it is often advisable, for the sake of clarity, to supplement them with examples illustrating their application.

C.6.3.1.3. Developing countries seeking to adopt transfer pricing legislation or revise existing legislation generally base such legislation on the arm's length principle, which is adopted in both the UN and OECD Model Conventions and in most national legislations throughout the world. As long as this remains the case, departures from the arm's length principle will create an increased risk of double or unexpected taxation, with no realistic prospect of cross-border relief. This could make the costs of doing business in the country concerned prohibitive and have the effect of discouraging cross-border trade and investment, with negative effects on sustainable development. While it is for each country to determine its own tax system, the desire to avoid double taxation has been an important factor in the very broad acceptance of the arm's length principle internationally.

C.6.3.1.4. Developing countries whose tax systems are at an early stage of development or who face severe resource constraints may choose, for practical reasons, to adopt an approach to transfer pricing that is simplified in comparison to that adopted by more developed countries and recommended by the OECD Guidelines. Where a simplified approach is adopted care should be taken, for the reasons noted above, to avoid results that depart from the arm's length principle. Where a country decides to adopt a simplified approach, it may be advisable to re-evaluate that decision periodically. A simplified approach may not continue to meet the needs of the tax administration as it addresses more complex transactions, or the approach may no longer be needed for practical reasons.

C.6.3.1.5. The setting of legislative priorities is obviously a matter for each country to decide for itself, in view of its particular circumstances and policies. Transfer pricing legislation may, for example, not be seen as a first priority by developing countries whose tax systems are still in a relatively early phase of legal development, especially if cross-border trade and investment are not yet significant in volume.

C.6.3.1.6. However, where a country that has not adopted specific transfer pricing legislation decides that it is appropriate to challenge a company's inter-company pricing it may find that it lacks a clear legal basis for such a challenge. While some countries may have general legal provisions or principles, such as general anti-avoidance rules or substance-over-form doctrines, they may find it difficult to successfully challenge inter-company pricing on this basis as transfer pricing is a specific fact oriented tax issue.

C.6.3.1.7. Such an approach may also raise issues of fairness to the taxpayer, if the application of general principles to inter-company pricing is not sufficiently clear and predictable. In such a case, this lack of certainty may create significant controversy.

C.6.3.1.8. Due to the above-mentioned considerations it is normally advisable for developing countries to adopt transfer pricing guidance as soon as they are in a position to do so and to examine transfer pricing practices to the extent possible.

C.6.3.2. Tax Audit Practices

C.6.3.2.1. Tax audit practices and policies play a key role in any effort by a tax administration to avoid or minimize disputes with taxpayers. To the extent that a tax administration's audit practices and policies are seen as fair and are implemented equitably it becomes less likely that taxpayers will see a need to pursue dispute resolution options. Conversely, where a tax administration has systematic integrity or confidentiality issues or

applies the law in a manner that is not seen as fair and equitable, or is regarded as unpredictable, taxpayers are more likely to see a need to seek resolution of the dispute elsewhere. All tax administrations seeking to avoid or minimize disputes with taxpayers should therefore devote significant attention to the operation of their tax audit practices and policies. Issues relating to tax audits are discussed in more detail in [Chapter C.5](#) of this Manual.

Advance Tax Rulings

C.6.3.2.2. Some countries have a practice of issuing advance rulings regarding the application of a country's laws to a taxpayer's particular facts (sometimes structured as unilateral Advance Pricing Agreements (APAs) in some countries – discussed in more detail below in the section on cross-border dispute avoidance procedures).⁴¹ These advance determinations can often be very helpful in avoiding disputes between that taxpayer and the tax administration.

C.6.3.2.3. When considering new issues tax administrations may initially prefer to provide guidance by a system of case-specific rulings so that they have an opportunity to consider the issues more fully before committing themselves to a general approach. On the other hand, where the issue is one of general application it may be more efficient for the tax administration to issue general guidance.

C.6.3.2.4. A heavy reliance on ad hoc rulings may also give rise to integrity concerns and associated equity issues unless there is a robust ruling review process in place. Where guidance is routinely provided by way of rulings it may prove difficult to strike an appropriate balance between legitimate taxpayer confidentiality concerns and the level of transparency that may be desired to issue an effective ruling. While it is generally best practice to maximize transparency, it would normally be inappropriate for the tax administration to publish case-specific rulings in their entirety as this would risk divulging sensitive taxpayer information to competitors. While many countries have a policy of publishing rulings after removing sensitive taxpayer information, even this approach may effectively disclose the identity of the taxpayer if these taxpayers operate in smaller markets, with negative consequences for the taxpayer's competitive position. It may therefore make sense for tax administrations to use case-specific rulings primarily to provide guidance on issues that are unique, novel or particularly difficult, or as an interim measure while adequate published guidance is being developed.

C.6.3.2.5. An alternative means of promoting transparency and consistent treatment of taxpayers, reportedly used by Nigeria, for example, is to publish generally applicable guidance on issues of broad application after analysing them in a cooperative relationship process with a particular taxpayer. Another possibility would be consultation processes with the business or industry sectors involved.

C.6.3.2.6. Some countries publish redacted copies of advance rulings in order to give guidance on current interpretations of the law as well as to provide transparency. In the case of unilateral advance rulings (including unilateral APAs) it should be noted that Inclusive Framework members are required to notify the affected state(s).

Cooperative relationships

C.6.3.2.7. In addition, tax administrations may wish to consider whether they should move towards a more cooperative relationship (sometimes referred to as an “enhanced relationship”) with some taxpayers and their advisors in order to get a better understanding of their business and transfer pricing practice. The Netherlands and the United Kingdom are widely seen as having already successfully implemented cooperative relationship programmes and other countries (such as Nigeria) are currently testing this approach.

C.6.3.2.8. A cooperative relationship can benefit tax administrations and taxpayers by offering greater certainty and transparency, an earlier and more efficient discussion on and resolution of any tax issues and lower administrative and compliance costs. It can also be used to resolve tax disputes or uncertainties for prior years more efficiently.

C.6.3.2.9. From a tax administration perspective interest in a cooperative relationship follows from the understanding that:

- Effective risk management requires current, relevant and reliable information regarding the taxpayer’s facts and potential tax issues, for which the taxpayer is the best source;
- A cooperative relationship makes the collection of any taxes owed more efficient, saving audit and litigation resources; and
- Tax payments will be received more quickly if disputes are avoided or resolved early in the process.

C.6.3.2.10. From the taxpayer’s perspective a cooperative relationship may be worthwhile because it can:

- Provide greater certainty and predictability regarding the taxation of the taxpayer’s investments, which is essential especially where significant investments are being considered;
- Expedite the resolution of tax issues; and
- Save costs by streamlining compliance and dispute resolution processes.

C.6.3.2.11. A cooperative relationship initiative tends to be administration resource intensive, however, and must be carefully implemented to ensure the consistent application of legal provisions, to protect taxpayer rights and to avoid integrity issues. While the manner in which tax administrators, taxpayers and tax advisors deal with each other is modified, applicable tax provisions should continue to be applied impartially. It is also important to implement cooperative relationship initiatives efficiently so that adequate audit resources can be devoted to less compliant taxpayers.

C.6.3.2.12. Development of a successful cooperative relationship requires that all parties engage on the basis of the following parameters:

- A genuine commitment to developing a relationship of mutual trust;
- A transparent and open approach;
- An understanding of commercial and industry aspects;

- An implementation process agreed at the start, including the designation of responsible persons at relevant levels of both the tax administration and the taxpayer; and
- Clear agreement in advance on the period to be covered.

C.6.3.2.13. Tax administrations may find it useful to adopt an industry-based focus where feasible, so that the experience gained can be leveraged and used to provide consistent and transparent treatment to similarly situated taxpayers (taking relevant differences into account).

C.6.3.4. Audit settlements

C.6.3.4.1. Many tax administrations, both developing and developed, rely heavily on case-by-case audit settlements to resolve disputes with taxpayers. To the extent audit settlements are based on clarifications and better understandings of relevant facts, this may be an effective use of limited resources. A disadvantage of audit settlements is that such settlements are often not very transparent, they are not necessarily coordinated to provide similar treatment to similarly situated taxpayers, and they are therefore not always perceived as being fair by stakeholders. Audit settlements may also raise more integrity concerns than some other dispute settlement procedures.

C.6.3.5. Advance Pricing Agreements/Arrangements (APAs)

C.6.3.5.1. Multinational businesses have often relied on Advance Pricing Agreements (APAs) (or “Advance Pricing Arrangements”, as some countries prefer) with tax authorities, especially in the framework of the Mutual Agreement Procedure. These APAs are so named because pricing methodologies are agreed in advance in relation to certain types of transactions, often called the “covered transactions”. APAs provide greater certainty for the taxpayer on the taxation of certain cross-border transactions and are considered by the taxpayers as the safest way to avoid double taxation, especially where they are bilateral or multilateral. The possible advantages and disadvantages of APAs for developing country administrations and taxpayers, including some implementation issues, are addressed below.

C.6.3.5.2. APAs were initially created by the National Tax Agency of Japan in 1987. The pre-confirmation system were unilateral in nature. In 1991, the IRS of the United States introduced APAs. The APA introduced by the IRS could be bilateral nature, utilizing the MAP provided in the applicable tax treaties.

C.6.3.5.3. APAs have been introduced in many countries. When APAs are bilateral or multilateral, they confirm the arm’s length result in advance by agreement between taxpayers and tax authorities in the relevant countries. They define agreed outcomes on certain sets of criteria (transfer pricing methods, comparables and appropriate comparability adjustments, critical assumptions as to future events, etc.) APAs are adopted not only by OECD member countries, but also by non-OECD member countries. Some countries also issue unilateral APAs. These unilateral APAs only involve the tax administration in one country and are therefore categorized as only partial solutions for

double taxation. Unilateral APAs can be considered useful in specific cases depending on all the facts and circumstances, but they usually do not provide a full solution to the problem of double taxation. The OECD Transfer Pricing Guidelines strongly endorse bilateral and multilateral APAs as a supplement to the traditional administrative, judicial and treaty mechanisms for resolving transfer pricing issues.⁴²

C.6.3.5.4. One of the key advantages of adopting an APA system is that uncertainty can be eliminated through enhancement of predictability of the taxation of international transactions. Developing countries thus have a good opportunity to obtain access to the existing documentation which is relevant to their local operations. A second advantage is that APAs can provide an opportunity for both tax administrations and taxpayers to consult and cooperate in a non-adversarial spirit and environment. Thirdly, an APA may prevent costly and time-consuming examinations and litigation of major transfer pricing issues for taxpayers and tax administrations. Fourthly, the disclosure and information aspects of an APA programme as well as the cooperative attitude under which an APA can be negotiated may assist tax administrations in gaining insight into complex international transactions undertaken by MNEs.

C.6.3.5.5. Tax administrations generally find APAs to be a more amicable process than the audit process followed by MAP. To the extent that there is advance agreement on key transfer pricing issues neither country faces the prospect of refunding taxes already collected. Furthermore, as the taxpayer provides extensive information in advance, the APA process is usually efficient in determining relevant facts. Perhaps for this reason many tax administrations have a general practice of suspending examination activity during APA discussions. Tax administrations may wish to clarify in their APA procedures that all information pertaining to the APA request should be shared simultaneously with both countries. Tax administrations have also found APAs to be useful tools for developing a deeper understanding of business operations, which can be used to inform their general guidance and examination processes. Most tax administrations have found that APAs are more widely embraced if APA and examination functions are kept separate. Alternatively, they may impose limitations on the use of some or all of the information provided by the taxpayer in the APA discussions for other purposes such as subsequent examinations or future litigation if an APA cannot be successfully concluded.

C.6.3.5.6. Tax administrations with severe resource limitations may wish to weigh the advantages of APAs against other resource needs. It may be difficult for a tax administration that is still developing its general audit capabilities to feel comfortable diverting substantial resources to an APA programme at that stage. Such countries may also be concerned that they will be at a disadvantage in negotiating APAs with MNEs or more experienced countries until they develop more experience, including experience with MAP cases. On the other hand, APAs can be useful on an interim basis as an efficient means of collecting tax in the short term, particularly in countries with a small number of large foreign investors. An APA can conserve resources but cannot replace the need for trained audit staff, so it can be beneficial for training to proceed in parallel while outside technical assistance and APA expertise is available.

⁴² OECD Transfer Pricing Guidelines (2017) paragraphs 4.1.3.4 to 4.1.76. In addition, see the Annex II to Chapter IV: Guidelines for Conducting Advance Pricing Arrangements under the Mutual Agreement Procedure (MAP APAs).

C.6.3.5.7. Countries with little transfer pricing experience may initially prefer to limit the terms of their APAs so they can evaluate the experience more quickly and adjust their practices if desired. A term of perhaps three years could be applied, rather than the five years more commonly used by experienced countries. Alternatively, they may wish to negotiate a few APAs in a pilot programme before committing themselves to a generally available, permanent programme.

C.6.3.6. Developing and operating an APA programme

C.6.3.6.1. It is important to establish an appropriate operational framework for an APA programme, to promote a consistent, principled approach and to ensure adequate review. Ideally, APA programmes should be established with a special unit comprised of trained staff designated for that function only. This would maximize the benefits of experience and promote an attitude of cooperation and transparency. If, due to resource limitations, APA programmes need to draw on expertise from other parts of the tax administration, it is important to establish safeguards to ensure that the APA process is not managed in the same way as a typical audit proceeding. Otherwise many of the benefits typically enjoyed by tax administrations in APA proceedings may be lost.

C. 6.3.6.2. At the same time, it is important to ensure that the APA programme operates in an appropriate manner within the framework of the tax administration as a whole. Procedures should be set up, for example, to prevent the APA programme from being used primarily to challenge the position of an audit team for past years. This may be achieved by requiring that the APA applies primarily to future years rather than past years. Organizationally, most tax administrations have tended to manage their APA programmes together with their MAP programmes and to organize them so that all cases with a particular treaty partner are handled by the same team. This facilitates the formation of closer working relationships between the teams from the two countries and promotes a better understanding of the other country's economy, legal provisions and administrative procedures. On the other hand, benefits may also be derived by comparing experiences on different cases within an industrial sector or by comparing the approaches of various treaty partners to similar issues. It is also important to establish procedures to facilitate the sharing of such knowledge, to strengthen technical analysis and to provide consistent treatment.

C. 6.3.6.3. Most tax administrations have found that an APA term of approximately five future years strikes the best balance between efficient use of resources and the uncertainties associated with prospective agreements. The risks associated with uncertainties can be minimized by specifying critical assumptions, based on which the APA will be renegotiated if necessary. It is fair to expect a renegotiation of the APA if the applicable law or the covered transactions change materially, but care should be taken not to impose excessively strict requirements on the continued application of an APA.

C.6.3.6.4. A tax administration's resources are normally best used to conclude APAs on complex issues. However, in the interest of fairness to smaller taxpayers who also need certainty, tax administrations may wish to consider establishing special simplified APA procedures for small and medium-sized enterprises (SMEs). A 2011 OECD survey of OECD member and observer countries found that a number of countries have adopted simplified measures for SMEs, small transactions and/or low value-added services and that Canada,

France, Germany, the Netherlands and the United States have simplified APA procedures for SMEs.⁴³ These programmes generally require SME taxpayers to provide less information and may also lower the application fee, if there is one.

C. 6.3.6.5. Some administrations charge taxpayers user fees for the conclusion of an APA, as a means of funding the programme. If reasonable in amount these fees have generally been accepted by taxpayers as outweighed by the advantage of the certainty provided by the APA. To avoid integrity issues, it is important that the fees be charged on a consistent basis (ideally reduced for small taxpayers), that they are paid into government funds and that they are refunded in the rare circumstances where an APA cannot be concluded. The Guide to the Mutual Agreement Procedure under Tax Treaties provides more guidance on best practices in the structuring and operation of APA programmes, and was approved by the Committee in October 2012.⁴⁴ Tax administrations may also want to refer to the Manual on Effective Mutual Agreement Procedures,⁴⁵ the Guidelines for Conducting Advance Pricing Arrangements under the Mutual Agreement Procedure (MAP APAs) in Annex II to Chapter IV of the OECD Transfer Pricing Guidelines,⁴⁶ and to the work of the EU Joint Transfer Pricing Forum on dispute resolution and APAs.⁴⁷ Finally, some national tax administrations, including those of Canada, India,⁴⁸ Japan, the United Kingdom⁴⁹ and the United States⁵⁰ have published detailed internal APA procedures. These may also provide useful comparative information.

C.6.3.7. Joint audits

C.6.3.7.1. Developing countries may also want to consider participating in joint audits. These are conducted by two or more tax administrations together to share information, save resources and minimize or expedite the resolution of controversies. Joint audits are still relatively new procedures, but they may prove useful for developing country tax administrations with fewer resources and less experience or subject-matter expertise in the industry or issues concerned. On the other hand, issues such as different languages, authority

⁴³ OECD, “Multi-country analysis of existing transfer pricing after simplification measures”, 10 June 2011. Available from <http://www.oecd.org/tax/transfer-pricing/48131481.pdf>.

⁴⁴ The Guide is available from http://www.un.org/esa/ffd/tax/gmap/Guide_MAP.pdf.

⁴⁵ More information available from <http://www.oecd.org/tax/dispute/manualoneffectivemutualagreementproceduresmemap.htm>.

⁴⁶ More information available from http://www.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations_20769717.

⁴⁷ Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee on the work of the EU Joint Transfer Pricing Forum in the field of dispute avoidance and resolution procedures and on Guidelines for Advance Pricing Agreement with the EU {SEC(2007) 246} is available from [https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/sec\(2007\)246_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/sec(2007)246_en.pdf).

⁴⁸ More information available from <http://www.itatonline.org/info/index.php/cbdts-advance-pricing-agreement-guidance-with-faqs/>.

⁴⁹ More information available from <https://www.gov.uk/hmrc-internal-manuals/international-manual/intm422010>.

⁵⁰ More information available from <http://www.irs.gov/pub/irs-drop/rp-06-9.pdf>.

to access foreign taxpayer information and differing accounting years and audit cycles may need to be addressed.

C.6.4. Domestic Dispute Resolution Procedures

C.6.4.1. Administrative appeals

C.6.4.1.1. A well-designed administrative appeals procedure can help ensure that the tax administration resolves its disputes with taxpayers in an efficient and fair manner. This will provide an added level of assurance to investors. To operate well and to be perceived as fair, an appeals procedure must be independent of other parts of the tax administration, so that it can provide an independent review of the dispute. It may not be as effective, from an institutional perspective, to have the case heard by the persons responsible for issuing the assessments or by their peers.

C.6.4.1.2. Countries seeking to avoid integrity issues may wish to consider using panels of decision-makers, as in India's Dispute Resolution Panel programme, or implementing additional levels of reviews, as in Nigeria's rulings practice. Brazil's Administrative Court of Tax Appeals (CARF) is an example of a successful administrative appeal procedure. Appeals are processed in three steps, the first step being within the tax administration while the second (the appeal) and the third (the special appeal, which is accepted under certain conditions) are decided by the CARF. The CARF is housed within the Ministry of Finance but is separate from the tax administration, even though that is part of the same ministry.

C.6.4.2. Mediation/conciliation

C.6.4.2.1. Mediation and conciliation are sometimes mentioned as potential procedures to resolve disputes. Mediation has proven successful in resolving tax disputes within developed economies. The most significant benefit of this approach towards dispute resolution is seen as the quick time frame within which disputes have been resolved. The mediation option may be made available as an administrative process within the tax administration, rather than as a separate independent mediation procedure outside of the administrative process. The process may be particularly promising in those situations where the tax auditor and taxpayer are no longer willing to communicate with each other and mutually resolve a dispute. In this environment, a mediator may be able to help overcome relationship challenges that prohibit the parties from reaching an agreement. While it may be worth testing these approaches, it should be noted that they are not automatically effective in a cross-border context, as they would still require an additional administrative step to obtain avoidance of double taxation. Potential utilization of similar processes in the treaty dispute resolution process is noted in paragraph C.6.5.1. below.

C.6.4.3. Judicial system

C.6.4.3.1. An independent judicial system that gives unbiased consideration to (tax) cases can do much to improve a country's reputation among investors as a jurisdiction where tax disputes can be fairly resolved.

C.6.4.3.2. However, owing to the call in the modern business world for real-time certainty regarding tax obligations, the perceived benefit of such a judicial system declines as the length of time to obtain a final decision grows. It is therefore important to ensure that the judicial system has adequate resources and that it is not unduly burdened by tax disputes due to real or perceived deficiencies at the audit and administrative appeals stages.

C.6.5. Dispute Resolution Procedures: Cross-Border

C.6.5.1. Tax Treaty Provisions

Division of taxing jurisdiction

C.6.5.1.1. Tax treaties significantly reduce the scope for cross-border disputes. Without a tax treaty, income from cross-border transactions or investment is subject to potential double taxation whenever the laws of the source and residence countries differ. Tax treaties seek to eliminate this double taxation by allocating between the contracting states the taxing jurisdiction over such income and by providing procedures for the relief of any residual double taxation. Treaties also typically require tax laws to be applied without discrimination based on nationality or capital ownership and without discrimination against the conduct of business through a permanent establishment.

C.6.5.1.2. Treaties therefore offer significant reassurance and certainty to potential investors, as well as greater certainty for tax administrations, by reducing the risk of cross-border disputes. In considering whether to make the negotiation of tax treaties a priority and which treaty negotiations to prioritize, developing countries may wish to weigh these advantages against the resources and the balance of bilateral concessions required to achieve an agreed treaty.

The mutual agreement procedure (MAP)

C.6.5.1.3. Tax treaties also provide for MAP; a cross-border dispute resolution procedure under Article 25 of both the UN and OECD Model Tax Conventions. MAP is operated by designated tax administration officials of each country who are referred to as “competent authorities”, and it enables tax administrations to reach bilateral agreement on issues of general interpretation or application and to thereby avoid double taxation on cross-border transactions and the resulting disputes. The MAP procedure is separate from, and additional to, domestic law remedies for dispute resolution. However, in many countries domestic law (and in particular a final court decision) can limit available solutions under MAP.

C.6.5.1.4. The MAP agreements may relate only to the assessments made in past years, or they may take the form of Advance Pricing Agreements (APAs) that provide for agreement on a transfer pricing methodology for future years (and in many cases past years as well) as explained in C.6.3.5. The MAP also applies to resolve cross-border disputes that have arisen in particular cases.

C.6.5.1.5. The UN Commentary on Article 25 (Mutual Agreement Procedure) provides useful guidance on dispute resolution through the MAP procedure, which is relevant for both transfer pricing and other tax disputes. The UN Committee of Experts on International Cooperation in Tax Matters (UN Committee) has adopted a Guide to the Mutual Agreement Procedure under Tax Treaties, which provides additional guidance on best practices in the

structuring and operation of MAP programmes based on practical experience, which developing countries may wish to evaluate and draw upon.⁵¹

C.6.5.1.6. Some tax administrations, including for example those of Canada,⁵² Germany,⁵³ India, Japan,⁵⁴ the Netherlands, the United States⁵⁴ and the United Kingdom,⁵⁵ have published detailed internal MAP guidance. These may also provide useful comparative information for tax administrations that wish to learn more about the MAP. It is useful for tax administrations to indicate their intention to follow published guidelines or to publish their own MAP guidance. This promotes consistency in case handling and transparency regarding the expectations of the tax administration. It may be advisable to enact provisions in domestic law allowing for MAP and APA procedures and, if necessary (and possible), an amendment to the constitution, in order to provide juridical certainty to such procedures.

C.6.5.1.7. The purpose of a MAP programme is to provide an effective means of reconciling differing positions of treaty partners, so that the treaty can operate as intended to avoid double taxation or other taxation not in accordance with the provisions of the treaty. Experience has shown that this purpose can best be achieved if the MAP programme is structured so that tax administrators implementing the MAP programme are able to make decisions independently of those implementing the audit programme and are free from outside influence.

C.6.5.1.8. Structural independence may be more difficult to achieve in smaller tax administrations, which may have a limited number of subject matter experts available to advise on such issues. Where, because of resource or other constraints, the same experts must be used for both audit and MAP programmes, it will be important to provide a procedure for effective independent review of proposed MAP positions in order to ensure that they are not unduly influenced by the views of auditors.

C.6.5.1.9. Freedom from political influence on the MAP process is equally important. Many tax administrations have found that this can be best achieved by placing the MAP function within the tax administration, rather than within the Ministry of Finance or other tax policymaking function. Such tax administrations believe it is helpful to establish procedures or practices preventing involvement by those outside the tax administration in decisions regarding particular MAP cases. Other countries believe that placing the MAP function within the Ministry of Finance is preferable, to reduce undue influence by the tax administration, or to facilitate coordination by policymakers. The importance of developing and operating well-functioning MAP processes was recognized and highlighted in Action

⁵¹ The Guide is available from http://www.un.org/esa/ffd/tax/gmap/Guide_MAP.pdf. Tax administrations may also want to refer to the OECD Manual on Effective Mutual Agreement Procedures (MEMAP) available from

<http://www.oecd.org/ctp/dispute/manualoneffectivemutualagreementproceduresmemap.htm>. The aim of the MEMAP is to make available to tax administrations and taxpayers basic information on the operation of the MAP under bilateral tax treaties and to identify best practices for MAP.

⁵² More information available from http://www.cra-arc.gc.ca/tx/nrrsdnts/cmp/mp_rprt_2014-2015-eng.html.

⁵³ More information available from https://www.nta.go.jp/foreign_language/MAP-Report/2015.pdf.

⁵⁴ More information available from http://www.irs.gov/irm/part4/irm_04-060-002.html.

⁵⁵ More information available from <http://www.hmrc.gov.uk/international/map.htm>.

14 of the OECD/G20 BEPS Project, resulting in the Action 14: 2015 Final Report “Making dispute resolution mechanisms more effective”.⁵⁶ The report contains a number of minimum standards and guidance on best practices some of which are discussed in the Commentary on Article 25 of the UN Model Convention in its 2017 update.

Operational considerations

C.6.5.1.10. Given their purpose, it is important for MAP procedures to be operated in a consistent manner rather than handling each case in an ad hoc fashion. This will provide for similar treatment of similarly situated taxpayers and help the MAP programme to be viewed as equitable and effective. Both operational structure and training and other capacity-building of the workforce can play important roles in promoting such consistency. For similar reasons, it is important for a MAP programme to apply principled approaches to resolving cases. In the first instance, the approaches taken should be consistent with the provisions of the treaty and any relevant interpretative guidance. It is essential that foreign and domestic taxpayers and “inbound” and “outbound” transactions be treated in the same manner. This will help produce consistent, predictable results and further contribute to a view of the MAP programme as equitable and effective. Training and other capacity-building will also be important.

C.6.5.1.11. It is also essential to implement a policy of broad access to MAP, if it is to serve the purpose of resolving cross-border disputes and be regarded by potential investors as equitable and effective. This calls for the elimination of factors that could otherwise prevent or discourage the use of MAP, including unreasonable time limitations or unilateral attempts to exclude selected issues from MAP. Consideration should be given to suspending the collection of disputed tax assessments on cases pending in MAP, as these assessments can otherwise present serious cash flow difficulties for taxpayers that have already been taxed on the same amount in the other country. If necessary, this can be done in exchange for a bank guarantee to ensure the payment of any tax due upon the conclusion of the MAP procedure. Similarly, consideration should be given to preventing the imposition of interest or at least preventing the imposition of higher interest rates that may effectively operate as penalty measures, while cases are pending in the MAP programme.

C.6.5.1.12. The MAP procedure generally commences with a request by a taxpayer addressed to the designated competent authority of a country for consideration of an issue for dispute resolution and/or relief of double taxation, because the taxpayer believes his tax treatment is not, or will not be, in accordance with the treaty. Alternatively, the process can be initiated because there are questions of interpretation or application of the convention or to eliminate double taxation in cases not otherwise provided for in the convention. The MAP process is intended to be used also to resolve economic double taxation, such as in the case of transfer pricing disputes. The case has to be presented to the competent authority of the country where the taxpayer is resident within three years from the (first) time the person is notified (for example by way of a notice of assessment) of the action that will result in taxation not in accordance with the convention. The three-year time limit is determined by the treaty article and may differ in certain cases. The definition of what constitutes (first) “notification” may be provided in domestic regulations. The form of the MAP request to be filed may be prescribed under domestic regulations as well. Alternatively, the commentary

⁵⁶ More information available from <http://www.irs.gov/pu>

to the treaty or the model convention may be consulted in this regard or the OECD Manual on Effective Mutual Agreement Procedures (MEMAP)⁵⁷ could also be consulted.

C.6.5.1.13. Once the MAP request has been received, it needs to be ascertained that the foreign competent authority is properly informed as well and that all relevant information to decide and agree on the matter is made available to both competent authorities. Considering the time limit within which competent authorities are expected to address and resolve a filed request, it is relevant to determine if further information is required from the taxpayer(s) involved or not, and if so, to request this information as soon as practicable. It would not be prudent to wait to ask for this information at the last minute and to extend or overrun the time limit provided by the applicable treaty. The competent authorities may wish to meet in person to compare notes on the matter and to explore available solutions or may wish to handle the matter through (electronic) correspondence or a combination of both of those approaches. It is generally understood that the competent authority of the country that made the primary adjustment leading to the double taxation (or taxation not in accordance with the convention) has the burden of proof towards the other competent authority that the primary adjustment is justified. That competent authority traditionally will send a letter (a so-called position paper) to the other competent authority informing the latter of its position with respect to the issue for which the competent authority request was filed. Based on the position paper, the other competent authority can respond and explore to what extent it agrees with the position and is able to provide for avoidance of double taxation or not.

C.6.5.1.14. If the competent authorities agree on a way to avoid double taxation and the taxpayer agrees to the suggested solution as well, a bilateral agreement is entered into between the two taxing authorities and an agreement is entered into between the respective competent authority and taxpayer of the country where the primary adjustment was made. Careful consideration is required on how the solution is to be implemented; in what taxable year and whether the statute of limitations is still open as regards that year in the other jurisdiction; or whether the treaty allows for an override of the domestic statute of limitation provisions. Consideration should also be given to whether the issue decided is a recurring issue (that applies to later years as well) or not. If the issue is a recurring issue and additional adjustments are to be expected for later years, the taxpayer and competent authorities may wish to explore to what extent they have the authority and means to resolve those years as well, or whether a new MAP request ought to be filed for later years.

MAP under the Inclusive Framework initiative

C.6.5.1.15. In accordance with the mandate of Action 14 of the BEPS Project, the concerned countries worked to "develop solutions to combat the obstacles that prevent countries from resolving disputes related to agreements through [MAP], including the absence of provisions on arbitration in the majority of countries' agreements and the fact that access to mutual agreement procedures and arbitration may be denied in some cases."

⁵⁷ Available from

<http://www.oecd.org/ctp/dispute/manualoneffectivemutualagreementproceduresmemap.htm>. The aim of the MEMAP is to make available to tax administrations and taxpayers basic information on the operation of the MAP under bilateral tax treaties and to identify best practices for MAP.

C.6.5.1.16. The measures agreed upon under Action 14 sought to strengthen the effectiveness and efficiency of this procedure by minimizing the risks of uncertainty and unintentional double taxation by ensuring consistent and appropriate implementation of tax treaties.

C.6.5.1.17. As a result of the final report of this action, a significant number of countries agreed to important changes in their position on dispute resolution regarding tax treaties and the commitment of countries in this regard represents a minimum standard. Through the minimum standard it will be ensured that:

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

C.6.5.1.18. Being a minimum standard of the Inclusive Framework, monitoring of the implementation of this commitment by countries is constantly monitored through peer review, which seeks to ensure that all countries that are part of the project comply with this standard.

C.6.5.1.19. The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Multilateral Instrument) developed pursuant to Action 15 of the BEPS Project, will facilitate compliance with the Action 14 minimum standard since it allows signatory countries to incorporate into their existing treaties, among other measures, those derived from Action 14 of the BEPS Project, which imply modifications to the Article on MAP. In other words, this Multilateral Instrument will make it possible to modify the existing agreements of the signatory countries, avoiding a large number of bilateral negotiations and the burden that the procedures for signing and ratifying separate amendments to treaties may present.

C.6.5.1.20. Within the context of arbitration, one of the main challenges in the framework of Action 14 was the question of mandatory arbitration as a means to ensure the resolution of disputes. This mechanism gives legal certainty to taxpayers about the resolution of a case in which they consider that a measure not conforming to the agreement was applied. Likewise, it encourages the competent authorities not to postpone the discussion of the case, in order to avoid this type of arbitration. Notwithstanding the foregoing, most of the countries participating in the BEPS Project have not chosen to include this alternative, with some of the main reasons that these countries have argued on account of sovereignty issues (i.e. not being able to accept that an arbitration panel decides on issues of domestic taxation), inexperience, distrust of the impartiality of the arbitrators, costs, and possible difficulties in finding specialists who can be appointed as arbitrators. It should be noted that the arbitration can be adopted through the Multilateral Instrument as an option and grants great flexibility with respect to the cases that may be subject to arbitration by allowing countries a reserve mechanism to exclude certain cases from the application of the same.

Arbitration

C.6.5.1.21. The UN Model Convention provides for an optional treaty text that allows the competent authorities to resolve the matter by way of arbitration, if no solution can be obtained within the time frame provided by the mutual agreement article. If that text is included in the treaty for the avoidance of double taxation, or agreement exists between treaty partners to resort to arbitration pursuant to that article, competent authorities that cannot find an acceptable solution for a dispute within the requisite time frame must invoke the arbitration procedures provided by the UN Model Convention or that may have been agreed to by the treaty partners otherwise.

C.6.5.1.22. Mandatory arbitration provisions have been added to many treaties in recent years as a last resort method of resolving MAP issues that cannot be resolved by the competent authorities within a specified time frame. The European Union began this trend in 1990 with the multilateral EU Arbitration Convention and the OECD amended its Model Convention and Commentary in 2008 to recommend the inclusion of mandatory arbitration provisions in bilateral tax treaties.

C.6.5.1.23 OECD statistics show that the MAP process succeeds in avoiding double taxation in 90 to 95 per cent of the cases to which its member countries are a party. While that is an impressive success rate for a dispute resolution programme that does not legally require the parties to reach agreement, the risk of double taxation in the remaining cases is still a serious concern for taxpayers and tax authorities, especially given the growing amounts in controversy. Both taxpayers and competent authorities tend to view arbitration very much as a last resort method. However, the inclusion of these arbitration provisions in treaties has been widely supported by taxpayers as they guarantee resolution within a specified time frame and provide certainty that double taxation will be avoided. In the vast majority of cases the practical effect of mandatory arbitration provisions has been to encourage the competent authorities to reach agreement by the specified deadline. Only a handful of cases out of the many hundreds of MAP cases submitted have been taken to arbitration under agreements concluded thus far.

C.6.5.1.24. Mandatory arbitration provisions have already been added to many treaties between OECD member countries, even where one country has a general preference for residence-based taxation and the other a general preference for source-based taxation. However, the UN Committee has endorsed arbitration only as an option and not as an affirmative recommendation. The envisaged arbitration process is described in the Commentary to Article 25 of the UN Model Convention.

C.6.5.1.25. As reflected in UN Commentary on Article 25, members of the UN Committee have identified arguments both in support of and against the adoption of mandatory tax treaty arbitration by developing countries. These arguments are summarized below.

C.6.5.1.26. It has been suggested that mandatory tax treaty arbitration may have the following potentially negative aspects from a developing country perspective:

- only a small number of cases are submitted to the MAP under paragraphs 1 and 2 of Article 25 and very few of them remain unresolved;
- domestic legal remedies can resolve the few cases that the competent authorities are not able to resolve through the mutual agreement procedure;

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- due to the lack of experience with MAP in many developing countries, arbitration would be unfair to those countries when the dispute occurs with more experienced countries;
- the interests of countries, which are so fundamental to their public policy, could hardly be safeguarded by private arbitrators in tax matters – arbitrators cannot be expected to make up for the lack of expertise in many developing countries;
- the neutrality and independence of possible arbitrators appears difficult to guarantee;
- it is very difficult to find experienced arbitrators;
- mandatory arbitration is costly and therefore not suitable for developing countries and countries in transition;
- it is not in the interest of a State to limit its sovereignty in tax matters through mandatory arbitration.

C.6.5.1.27. Those who support the inclusion of mandatory arbitration provisions in tax treaties have argued that these provisions will have certain benefits for developing countries and can be designed in the following ways to address their concerns:

- despite the fact that only a small number of cases remain unresolved, each of these cases represents a situation where there is no resolution for a case where one competent authority considers that there is taxation not in accordance with the Convention and where there may be significant double taxation;
- arbitration provides more certainty to taxpayers that their cases can be resolved under the MAP and contributes to the promotion of cross-border investment;
- domestic remedies may not adequately and rapidly resolve disputes concerning the application of bilateral conventions (risk of inconsistent court decisions in both countries and of unilateral interpretation of the Convention based on domestic law);
- the obligation to submit unresolved cases to arbitration after a given period of time may facilitate the endeavours of the competent authorities to reach an agreement within that period of time;
- on the basis of the experience under the EU Arbitration Convention, the effective recourse to mandatory arbitration should be rather unusual and the costs relating to that mechanism should be low; moreover, as arbitration provides more certainty to the taxpayers, it reduces the number of costly “protective” appeals and uncertain domestic proceedings;
- arbitrators have to reach a well-founded and impartial decision; consequently, they can adjust for the levels of expertise of countries and overcome the possible lack of experience of some countries;
- skilled and impartial arbitrators can be drawn from various backgrounds (government officials, judges, academics and practitioners) and from various regions (including from developing countries);

- it is in the interest of a State to limit its sovereignty in tax matters through mandatory arbitration.

C.6.5.1.27. One of the main challenges in the framework of Action 14 was the question of mandatory arbitration as a means to ensure the resolution of disputes. This mechanism gives legal certainty to taxpayers about the resolution of a case in which they consider that a measure not conforming to the agreement was applied. Likewise, it encourages the competent authorities not to postpone the discussion of the case, in order to avoid mandatory arbitration. Notwithstanding the foregoing, most of the countries participating in the BEPS Project have not chosen to include this alternative, with some of the main reasons similar to those addressed above. It should be noted that the arbitration can be adopted through the Multilateral Instrument as an option and grants great flexibility with respect to the cases that may be subject to arbitration by allowing countries a reserve mechanism to exclude certain cases from the application of the same.

Non-binding dispute resolution procedures

C.6.5.1.28. The UN Committee in October 2015 approved the formation of a Subcommittee to address, consider and report back on dispute avoidance and resolution aspects relating to the MAP, with a view to reviewing, reporting on and, as appropriate, considering possible text for the UN Model and its Commentaries, and related guidance, on a variety of issues, including:

- Options for ensuring the MAP procedure under Article 25 (in either of its alternatives in the UN Model) functions as effectively and efficiently as possible;
- Other possible options for improving or supplementing the MAP procedure, including the use of non-binding forms of dispute resolution such as mediation;
- Exploration of issues associated with agreeing to arbitration clauses between developed and developing countries; and
- The need or otherwise for any updates or improvements to the Guide to the Mutual Agreement Procedure under Tax Treaties.⁵⁸

C.6.5.1.29. On 20 October 2017, the Subcommittee on Dispute Avoidance and Resolution was established and has been discussing the dispute avoidance and resolution without focusing on transfer pricing. The work of the Subcommittee will result in a manual on dispute resolution, a useful guide for developing countries on the design and implementation of various dispute resolution mechanisms.

C.6.5.2. Multilateral Approaches

C.6.5.2.1. Multilateral approaches are important tools to avoid cross-border disputes on transfer pricing and the resulting risks of unrelieved double taxation.

C.6.5.2.2. As noted above many countries have historically relied primarily on the guidance provided by the OECD Transfer Pricing Guidelines, which interpret Article 9 (Associated Enterprises) of the OECD Model Convention and have been developed by

⁵⁸ http://www.un.org/esa/ffd/tax/gmap/Guide_MAP.pdf

transfer pricing experts over the past several decades. A number of economies in transition and developing countries have adopted domestic transfer pricing laws that extensively draw upon the provisions of the OECD Transfer Pricing Guidelines. These include, for example, China, Egypt, India, Malaysia and South Africa.

C.6.5.2.3. Although the provisions of Article 9 of the UN Model Convention are very similar to Article 9 of the OECD Model, the interpretation provided by the OECD Transfer Pricing Guidelines may not be fully consistent with the policy positions of all developing countries. However, in recent years, representatives of China, India, and other non-OECD economies have begun participating actively as observers in the development of transfer pricing guidance at the OECD level. Non-OECD/G20 countries also participated on an equal footing in the revision of OECD transfer pricing guidance as participants in the OECD/G20 Inclusive Framework initiative.

C.6.5.2.4. The Commentary to Article 9 of the UN Model as revised in the 2017 update also recognizes the importance of maintaining a common understanding of how the arm's length principle should be applied in order to avoid international double taxation of corporate profits. To that end the Committee of Experts considered that the OECD transfer pricing guidelines contain valuable guidance relevant for the application of the two Model Conventions, and consistency with the OECD transfer pricing guidelines has been sought when developing this Manual. Therefore, developing countries may wish to consider the relevance of the OECD Transfer Pricing Guidelines, along with the growing body of UN guidance and other available sources, when establishing their own domestic and cross-border policies on transfer pricing.

C.6.5.3. Coordination of Domestic and Cross-Border Dispute Resolution Procedures

C.6.5.3.1. Each country will have its own domestic dispute resolution procedures in addition to cross-border procedures. It is important that these be properly coordinated for two reasons.

C.6.5.3.2. First, tax administrations, especially developing country administrations with limited resources, may want to minimize duplication of effort by avoiding the simultaneous operation of two parallel dispute resolution processes. Most tax administrations prefer to deal with an issue either through MAP or through domestic procedures, but do not generally operate both procedures simultaneously (with the exception of certain simultaneous MAP and domestic appeals programmes).

C.6.5.3.3. Second, notwithstanding such resource concerns, it is important to manage any duplication issues without forcing taxpayers to make a premature choice between domestic and cross-border procedures. For example, taxpayers should not be required to give up their MAP rights under treaties in order to access domestic administrative appeals procedures. To avoid such results, while addressing resource constraints, many tax administrations permit taxpayers to preserve their rights to domestic procedures during MAP discussions by placing them on hold (usually after filing an initial notice of objection) so that they can later pursue their domestic rights if no MAP agreement is reached. Alternatively, tax administrations may wish to provide flexibility in the timing of MAP by not setting a deadline for MAP requests under their treaties or domestic laws, so that appropriate domestic procedures can

be explored first. Some tax administrations prefer instead to set a deadline for the filing of a MAP request.

C.6.5.3.4. Taxpayers should be permitted, however, to pursue MAP consideration of a relevant cross-border issue or issues while pursuing domestic dispute resolution procedures for separate issues that are not appropriate for MAP.

C.6.5.3.5. In some countries there is a view that the tax administration, including the competent authority, is bound by a final decision of a domestic court and that MAP consideration is not available in such circumstances. Some other countries view this as inconsistent with the obligations of the treaty MAP provisions. Where a competent authority takes the view that it cannot or should not depart from domestic court decisions it should clearly state this position in public guidance for the information of treaty partners and taxpayers.

C.6.5.3.6. The competent authority of one country is, of course, not obligated in any way to accept either a court decision or an administrative settlement of another country. Of course, the competent authority may choose to provide relief on a unilateral basis if it agrees with the result reached, but it should not be expected to provide relief solely because it is otherwise unavailable.

South Africa – Country Perspective

1. Introduction

- 1.1. Transfer pricing remains a strategic focus area for the South African Revenue Service (SARS), forming an integral part of SARS' compliance programme. As South Africa has gone through low economic growth in recent years and the global COVID 19 pandemic, the focus remains on identifying and challenging structures that lead to profit shifting and mispricing.

2. South African Transfer Pricing Landscape

- 2.1. The fundamental principle underpinning South African transfer pricing legislation, since inception, has been the arm's length principle as set out in Article 9 of both the United Nations Model Double Taxation Convention between Developed and Developing Countries and the OECD Model Tax Convention on Income and on Capital. The UN Practical Manual on Transfer Pricing reinforces the principle for Developing Countries and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Transfer Pricing Guidelines).
- 2.2. South Africa's transfer pricing legislation is set out in section 31 of Income Tax Act (Act No. 58 of 1962) (Income Tax Act), and came into effect on 1 July 1995. This was followed by Practice Note 7 dealing with transfer pricing (published on 6 August 1999) which serves to provide taxpayers with guidance on how SARS interprets the legislation.
- 2.3. In 2012, South Africa introduced the Tax Administration Act (Act No. 28 of 2011) (Tax Administration Act), which was to incorporate in a single piece of legislation certain generic tax administrative provisions, which were duplicated in different tax Acts. The Tax Administration Act is therefore applicable for compliance and administration of the transfer pricing legislation.
- 2.4. Important legislative amendments to both the Income Tax Act and the Tax Administration Act are highlighted in paragraph 4 below.

3. Recent Developments

Domestic

- 3.1. South Africa's Minister of Finance announced in February 2013 that the government would initiate a tax review to assess South Africa's tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability. A committee known as the "Davis Tax Committee" (DTC) was inaugurated and the Committee's Terms of Reference were announced in July 2015.
- 3.2. The OECD/G20 BEPS Project was launched in September 2013 with South Africa participating as an equal partner. As a result, the DTC set up a BEPS Sub-Committee to address its concerns around base erosion and profit shifting and to formulate the DTC's position in this regard. The DTC consulted with various stakeholders from business representatives, trade unions, civil society organisations, tax practitioners, SARS, National Treasury, the South African Reserve Bank, members of international bodies and academics, in releasing its "BEPS First Interim Report" for public comment by 31 March 2015. The final report was released in July 2016.
- 3.3. After review and evaluation, SARS has implemented certain of the DTC's recommendations relating to documentation, tax returns and building capacity in the transfer pricing division.

International

- 3.4. South Africa is not a member of the OECD but has the status of being a participant in the Committee on Fiscal Affairs and as an associate to the Base Erosion Profit Shifting (BEPS) project for the G20 in 2013. South Africa is thus an associate to the Inclusive Framework on BEPS from 2016. However, as part of the OECD/G20 BEPS Project, South Africa was an associate on equal footing alongside OECD member countries. The BEPS Project raised areas of improvement for South Africa, especially in relation to asymmetry of information, resulting in legislative and administrative changes.

4. Legislative and Administrative Framework

Section 31 of the Income Tax Act

General

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- 4.1. The most significant legislative amendments since the inception of the transfer pricing legislation came into effect in 2012, *inter alia* consolidating the transfer pricing and thin capitalisation provisions.
- 4.2. The ambit of section 31 was widened to consider any transaction, operation, scheme, agreement or understanding that was entered into between a South African resident and an offshore-connected person (including permanent establishments and controlled foreign companies) for the benefit of a South African resident.
- 4.3. With the overhaul of the transfer pricing legislation, taxpayers bear the onus of demonstrating that the transactions entered into are at arm's length.

Connected Persons

- 4.4. One of the requirements for the transfer pricing provisions to apply, is a connection between the entities. Section 1 of the Income Tax Act defines this connection as a “connected person”.
- 4.5. With effect from 1 January 2022, the connection requirement is further widened by the inclusion of associated enterprises, defined as an associated enterprise as contemplated in Article 9 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development.

Secondary Adjustments

- 4.6. From 2015, the secondary adjustment provision was amended and the difference between taxable income on an arm's length basis and taxable income on the non-arm's length basis is deemed to be a distribution of an asset *in specie* in the case of a company and a donation in the case of any other type of taxpayer.
- 4.7. No treaty relief is available for dividends tax as a deemed dividend *in specie* for transfer pricing purposes has been specifically excluded from the definition of dividend in section 1 of the Income Tax Act.
- 4.8. As the taxpayer bears the onus to demonstrate that it transacted at arm's length, voluntary adjustments made after a tax return has been filed will also incur the secondary adjustment.

Thin Capitalisation and Financial Transactions

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- 4.9. As a result of the legislative changes to the transfer pricing provisions in 2012, the thin capitalisation provisions changed from a safe harbour of a 3:1 debt to equity ratio to an arm's length test.
- 4.10. The financial transactions paper issued by the OECD in February 2020 furthermore guides SARS on financial transactions.
- 4.11. Section 23M of the Income Tax Act provides a limitation on the deduction of excessive interest, which is also applicable to cross border financial assistance transactions between certain connected persons.
- 4.12. National Treasury is currently undertaking further work on the limitation of excessive debt and has published a paper titled "*Reviewing the tax treatment of excessive debt financing, interest deductions and other financing payments*" for public consultation on 26 February 2020. The deadline for submission of public comments on the draft paper is 30 September 2020.

Transactions to which the Transfer Pricing Provisions are not applicable

- 4.13. In order to eliminate the potential for double taxation described above, it was legislated that the transfer pricing provisions would not apply to certain cross-border financial assistance transactions (e.g. loans) and certain cross-border uses of intellectual property. More specifically, transfer pricing will not apply to holders (i.e. creditors) of a loan or holders of intellectual property if:
 - 4.13.1. The holder is a South African company;
 - 4.13.2. The obligor is a controlled foreign company (CFC) in relation to the South African holder and 10 per cent of the equity shares and voting rights in the obligor is directly owned by that holder (whether alone or together with any other company forming part of the same group of companies as the holder);
 - 4.13.3. The CFC has a foreign business establishment; and
 - 4.13.4. The CFC is taxed at a comparable rate (an aggregate effective rate of 67.5 per cent of the South African rate that would otherwise be imposed). For purposes of this 67.5 per cent threshold, foreign taxes on income imposed by all foreign spheres of government (national, provincial and local) must be taken into account. The calculation of the aggregate effective rate also takes into account

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all income tax treaties, rebates, credits or other rights of recovery. Lastly, the rate is calculated after disregarding carryover losses as well as group losses.

- 4.14. With regard to the provision of financial assistance and licensing of intellectual property to a controlled foreign company, the Explanatory Memorandum¹ explains the reason for the introduction of the provisions mentioned above: *“South African companies often make interest-free loans to controlled foreign subsidiaries for non-tax reasons. These soft-loans often operate as an implicit form of share capital (i.e. lacking interest and fixed dates of repayment). The purpose of these loans is mainly to allow for the seamless withdrawal of funds for foreign company law and to alleviate certain adverse impacts of foreign exchange controls. As such, these soft loans are an important method of indirectly funding offshore start-up operations. South African companies may also provide yield-free licenses (and other forms of yield-free intellectual property) to controlled foreign subsidiaries for similar non-tax reasons. The lack of yield for these instruments unfortunately has undesirable side-effects for tax purposes. The South African holder may be subject to transfer pricing concerns, thereby being subject to tax based on a higher notional yield. On the other hand, the foreign company obligor will often be allowed a foreign deduction only for actual cross-border payments to the South African company (as opposed to a foreign deduction for the higher notional payments). The net result is a potential de facto double taxation; a result that reduces the international competitiveness of South African multinationals.”*
- 4.15. Furthermore, where a South African resident company (or any company that forms part of the same group of companies as the South African resident company) grants financial assistance to a foreign company in which the South African resident (whether alone or together with any other company that forms part of the same group of companies as the South African resident company) constitutes a debt owed by that foreign company to that resident company (or any company that forms part of the same group of companies as the South African resident company), the foreign company:

¹ Explanatory Memorandum on the Taxation Amendment Bill, 2012, dated 10 December 2012, paragraph 5.8. Web Link: <https://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2012-01%20-%20Explanatory%20Memorandum%20Taxation%20Laws%20Amendment%20Bill%202012.pdf>

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- is not obliged to redeem that debt in full within 30 years from the date the debt is incurred;
- the redemption of the debt in full by the foreign company is conditional upon the market value of the assets of the foreign company not being less than its market value of the liabilities; and
- no interest accrued during the year of assessment.

Tax Administration Act

Income Tax Returns

- 4.16. Substantial improvements to increase disclosure requirements of transfer pricing and other BEPS related transactions have been made to the corporate income tax return.

Documentation

- 4.17. Prior to 2016, South Africa did not have specific statutory transfer pricing documentation requirements. Following the BEPS project and the recommendations made by the DTC, the specific statutory documentation retention requirements set out below were introduced by public notice² in terms of section 29 of the Tax Administration Act in 2016 for transfer pricing. The extent of the documentation to be kept is tiered according to the reasonably expected value of the transaction:

4.17.1. Records, books of account or documents in respect of the structure and business operations; and

4.17.2. Records, books of account or documents to be kept in respect of the affected transactions.

- 4.18. Country-by-Country reporting, master file and local file requirements for large multinational enterprises were also introduced by public notice³ in terms of section 25 of the Tax Administration Act in 2016.

² Web link: <https://www.sars.gov.za/AllDocs/LegalDoclib/SecLegis/LAPD-LSec-TAdm-PN-2016-05%20-%20Notice%201334%20GG%2040375%2028%20October%202016.pdf>

³ Web link: <https://www.sars.gov.za/AllDocs/LegalDoclib/SecLegis/LAPD-LSec-TAdm-PN-2017-02%20-%20Notice%201117%20GG%2041186%2020%20October%202017.pdf>

Access to information

4.19. One of the key challenges in any transfer pricing analysis is access to information. This is a widespread problem not unique to South Africa and indeed was also acknowledged in the BEPS project. Over the years SARS had been challenged on a number of fronts regarding its information requests including, *inter alia*:

- SARS' right to certain categories of information. Taxpayers have argued for the non-submission of information on the basis that such information is commercially sensitive, irrelevant and out of scope, not accessible, or legally privileged;
- taxpayers requesting numerous extensions of time within which to comply with a SARS information request to the point that the statute of limitation runs out for SARS or that it becomes almost impossible for SARS to review such information before the statute of limitations runs out; and
- taxpayers have challenged SARS's powers to interview persons and personnel that may have information relevant to the transaction under audit.

4.20. To address the above information related challenges, the following legislative amendments have been effected to the Tax Administration Act:

4.20.1. The overarching provisions of section 46 clarifying the information gathering powers of SARS to be that SARS can request information that is relevant or foreseeably relevant. There is no onus on SARS to explain or justify information requests. However, it was acknowledged that legal professional privilege was an exceptional situation. For this reason, section 42A of the Tax Administration Act was introduced clarifying the requirements to be met by taxpayers failing to submit relevant information to SARS on the basis of legal professional privilege and the process to be followed to resolve the issue;

4.20.2. Amendment to section 46 with respect to access to foreign based information and to ensure that, where a matter progresses to dispute resolution, taxpayers are held to any assertions that they were unable to access information located offshore. Where a taxpayer makes such an assertion, the taxpayer may, under certain circumstances, be prohibited from submitting such information at a later stage;

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4.20.3. Amendment to section 47 clarifying persons who may be interviewed or called upon to provide information on a taxpayer/company/entity under audit. Important to this amendment is the existing requirement in terms of section 49 of the Tax Administration Act, which allows SARS to request such persons to be interviewed under oath or solemn declaration.

Statute of Limitation

4.21. There is a general three-year statute of limitation for assessments by SARS to execute and conclude any audit. The statute of limitations may be further extended in terms of section 99 of the Tax Administration Act:

- The statute of limitation may be extended by agreement between SARS and the taxpayer;
- SARS may extend the statute of limitations by prior notice by a period approximate to the delay of the taxpayer in providing relevant material within the required time period; and
- This statute of limitations period can also be extended by SARS, with prior notice to the taxpayer, for a period of three years where an audit or investigation relate to transfer pricing, the application of substance over form, the general anti-avoidance rule or the taxation of hybrid entities or hybrid instruments.

5. Year-End Adjustments

5.1. There appears to be an increasing tendency for parent companies of South African subsidiaries to shift profits via a year-end adjustment to either the cost of goods imported by the South African subsidiary or directly to the operating margin, to bring the South African subsidiary in line with “comparable companies”. What occurs is usually a global policy change by the parent company aimed at limiting the return of its subsidiaries (including those based in South Africa) to a guaranteed return (determined by way of a comparable search). The change in policy is often followed by an introduction of year-end transfer pricing adjustments to ensure that South African entities achieve the often low targeted net margin while the residual profit is returned to the parent or holding company.

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- 5.2. There is little or no regard for the drivers of higher profits attained in South Africa when comparing them to comparable companies in foreign markets (given there are no local comparables for South Africa) or consideration for the actual functional and risk profile of the South African subsidiary. South African subsidiaries of multinational companies are frequently classified as limited risk distributors or limited risk manufacturers when in actual fact they assume much more than just limited risk.
- 5.3. Further, there are many instances where unique dynamics exist within the South African market that enable South African subsidiaries to realise higher profits than their connected party counterparts in other parts of the world or than is evidenced by comparable data obtained from foreign databases. The increased participation and spending power of the middle class segment in the economy also offers a new market opportunity for certain industries.
- 5.4. Year-end adjustments that result in an under declaration of income tax, will incur the secondary adjustment, penalties and interest. Furthermore, as there may have been under declaration of customs duty and import Value-Added Tax (VAT), additional customs duties and VAT may be payable.

6. Comparability

- 6.1. The main challenge that South Africa has in determining arm's length profits has been the lack of domestic comparables. It is thus accepted that the most reliable comparables will suffice. The problem in South Africa is that this compromise is exacerbated even further given that databases contain extremely limited South African specific, or for that matter, Africa specific, comparable data. As a result, both the tax administration and taxpayers often rely on European databases to establish arm's length levels of profitability.
- 6.2. Instituting comparability adjustments to account for geographical differences (for example, market, economic and political differences) in order to improve the degree of reliability of the comparable data, is often extremely complex and can in some instances have the reverse effect, i.e. where the comparable data is no longer comparable.
- 6.3. In practice, SARS has attempted to make comparability adjustments, for example, country risk adjustments based on publicly available country risk ratings and government

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bond rates (sometimes referred to as the risk free rate). However, these have been applied with caution and in specific circumstances.

- 6.4. Whilst South Africa may be worse off than some countries in having extremely limited domestic comparable data, many other countries are likely to be in a similar position. As multinationals become more and more complex in their business models, and as more widespread industry consolidation is achieved, finding comparable data and achieving reliability may not be South Africa's problem alone. It is perhaps already true that for certain types of large scale manufacturing and distribution activities, for example in the automotive industry there is no independent comparable data available anywhere.
- 6.5. It is for this reason, amongst others, that SARS favours a more holistic approach to establishing whether or not the arm's length principle has been complied with. By seeking to understand the business model of taxpayers across the whole value chain, gaining an in-depth understanding of the commercial sensibilities and rationalities governing intra-group transactions and agreements, it is evident that SARS does not look to comparable data alone or in isolation from other relevant economic factors in determining whether or not the appropriate or arm's length level of profit has been achieved.

7. Intangibles

- 7.1. As intangibles are often "unique" in nature they raise unique transfer pricing challenges for both multinationals and tax administrations. Disputes that arise in South Africa relate to the existence of local marketing intangibles, issues of economic versus legal ownership and the valuation of intangibles. The revised guidance in Chapter 6 of the OECD Transfer Pricing Guidelines as a result of the BEPS Project was welcome and provides helpful guidance for developing countries.
- 7.2. In the South African experience, the sale of South African developed intangibles presents a somewhat exceptional situation compared to the rest of the world, as exchange control regulations prohibit the export of South Africa developed intangibles, in the absence of approval by the Financial Surveillance Department of the South African Reserve Bank. Once the worldwide (excluding South Africa) intangible property is sold to an offshore connected party, usually in a low tax jurisdiction, the connected party becomes the legal owner of the intangible property for the rest of the world, excluding South Africa. This

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connected party then licences out the intangible property worldwide (excluding South Africa) earning royalties. In addition, terms and conditions of the original sale may dictate that the South African entity will continue to perform certain functions toward the enhancement and further development of the intangible property for which it earns a cost plus return. The connected party, that is now the legal owner, in essence merely carries out activities relating to registration and maintenance of the intangible property and earns an intangible connected return (in the form of royalties). Furthermore, if such intangible property were ever sold outside of the group, the South African entity would have no participation in any profits that may be realised.

- 7.3. South Africa has enacted anti-avoidance provisions to limit BEPS in relation to IP payments. This is in the form of Section 23I of the Income Tax Act that denies a general deduction in respect of fees paid for the use of IP where the IP was originally developed in SA and subsequently migrated to a foreign jurisdiction for licensing back to SA.

8. Intra Group Services

- 8.1. As a result of an increase in globalisation, in order to achieve economies of scale and optimise efficiencies, it is becoming commonplace for multinationals to centralise the provision of certain services in a single entity, generally in a tax advantaged jurisdiction.
- 8.2. South Africa has consistently stated that it will not be applying the simplified approach to low value adding services, as outlined in the final BEPS report.
- 8.3. In essence, Chapter 7 of the OECD Transfer Pricing Guidelines set out the approach that in establishing the arm's length nature of intra-group services, the test is twofold. Firstly, it must be determined if a service has been rendered and secondly it must be determined if the charge for such service is arm's length (paragraph 7.5 of the OECD Transfer Pricing Guidelines). As relates to the first part of the test, the approach followed is to determine if the services:
- provide the recipient with economic and commercial benefit (now called the “Benefits Test” in the revision to Chapter 7);
 - are not services that the recipient is already performing for itself (duplicate service test); and
 - are not shareholder services.

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- 8.4. As regards the second part of the test, the audit approach seeks to confirm the following:
- that the cost base is appropriate to the services provided;
 - that the mark-up is arm's length; and
 - that the allocation keys applied are commensurate to the services provided.
- 8.5. In particular, paragraph 7.29 of the OECD Transfer Pricing Guidelines states that in determining the arm's length price for intra-group services, the matter should be considered from the perspective of the service provider and the recipient. Relevant considerations include the value of the service to the recipient as well as the costs to the service provider.
- 8.6. SARS is currently taking a pragmatic but firm approach to evaluating payments for intra-group services and where clear commercial justification or reasonableness for those payments is lacking, the payments are disallowed.

9. Dispute Resolution

- 9.1. Once an assessment has been raised, the taxpayer may lodge an objection against such assessment.
- 9.2. Currently the Alternative Dispute Resolution (“ADR”) mechanism allows for resolving a dispute other than through litigation. The ADR process is governed by the rules promulgated under section 103 of the Tax Administration Act.
- 9.3. SARS and the taxpayer can initiate the ADR mechanism once the taxpayer has lodged an Appeal against the disallowance of an objection against an assessment. SARS, however makes the final decision as to whether a matter is suitable for ADR.
- 9.4. A facilitator, who will endeavour to resolve the dispute, facilitates the ADR meeting between the taxpayer and SARS. The taxpayer and SARS may agree in certain instances not to use a facilitator, in which case the taxpayer and SARS will endeavour to resolve the dispute.
- 9.5. If a matter is not resolved during ADR, the litigation route may be followed.

10. Exchange of Information

- 10.1. The majority of South Africa's Double Taxation Agreements (“DTA”) contain an Article dealing with the exchange of information.

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10.2. In addition, South Africa has entered into the following categories of Exchange of Information Conventions/Agreements⁴:

- USA FATCA Intergovernmental Agreement – The [USA FATCA Intergovernmental Agreement](#) is an agreement between the governments (tax administrations) of the United States of America and the Republic of South Africa to exchange information automatically under the provisions of the double taxation agreement between these countries. The Standard for Automatic Exchange of Financial Account Information (the Standard or the CRS) is a standardised automatic exchange model, which builds on the FATCA IGA to maximise efficiency and minimise costs, except that the ambit is now extended to all foreign held accounts and not only those of US citizens. South Africa is also one of the early adopters of the CRS;
- Multilateral Mutual Administrative Assistance (“MAA”) Conventions / Agreements - agreements between the governments (tax administrations) of two or more jurisdictions to enable them to exchange tax information on request, spontaneously or automatically, as well as to provide assistance in the collection of taxes;
- Bilateral Tax Information Exchange Agreements (“TIEAs”) - agreements between the governments (tax administrations) of two jurisdictions to enable them to exchange tax information upon request;
- Double Taxation Agreements (“DTA”) – agreements between two tax administrations to two countries to enable the administrations to eliminate double taxation;
- Bilateral Common Reporting Standard Competent Authority Agreements (“CRS CAAs”) / MoUs - bilateral agreements between the Competent Authorities of two jurisdictions to enable them to exchange information under the CRS; and
- Bilateral Country-by-Country Competent Authority Agreements (CbC CAAs) / MoUs - bilateral agreements between the Competent Authorities of two jurisdictions to enable them to exchange CbC reports.

⁴Web link: [https://www.sars.gov.za/Legal/International-Treaties-Agreements/Pages/Exchange-of-Information-Agreements-\(Bilateral\).aspx](https://www.sars.gov.za/Legal/International-Treaties-Agreements/Pages/Exchange-of-Information-Agreements-(Bilateral).aspx)

11. Mutual Agreement Procedure (MAP)⁵

- 11.1. Different positions taken by two or more administrations, on what constitutes arm's length conditions for a transaction between associated enterprises, can lead to economic double taxation. Article 25 OECD Model Tax Convention enables competent authorities to consult with each other with the view to resolve taxation not in accordance with the Convention. This also applies in the context of transfer pricing problems relating to economic double taxation. South Africa provides access to MAP in transfer pricing cases in particular. DTA provisions such as Article 9(2) of the OECD Model Tax Convention or, in the absence of Article 9(2) of the OECD Model Tax Convention, provisions of domestic law enable contracting jurisdictions to provide for a corresponding adjustment with the aim of avoiding double taxation.
- 11.2. A MAP case is a transfer pricing MAP case where the taxpayer's MAP request relates to:
- 11.2.1. the attribution of profits to a permanent establishment (Article 7 of the OECD Model Tax Convention)⁶, including the determination of whether a permanent establishment exist in a contracting jurisdiction (Article 5 of the OECD Model Tax Convention); or
- 11.2.2. the determination of profits between associated enterprises (paragraph 1 of Article 9 of the Model Tax Convention) and the corresponding adjustments to be made in pursuance of paragraph 2 Article 9 of the OECD Model Tax Convention and assessing whether they are well founded and for determining the amount.
- 11.3. Under normal circumstances, secondary adjustments (discussed at paragraphs 4.6 to 4.8 above) are reversed if the primary adjustment is reversed or, if the taxpayer repatriates funds from the non-resident equivalent to the amount of the transfer pricing adjustment. In these two instances, relief from the secondary adjustment should be a consequence of the MAP settlement.
- 11.4. A transfer pricing MAP case does not include a request for an APA. See section 12 below.

⁵ SARS Guide on Mutual Agreement Procedures, Issue 3 (20 March 2020), paragraph 2.1.3

⁶ South Africa has not adopted the Authorised OECD Approach ("AOA") and has raised a reservation in this regard.

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- 11.5. In determining if taxation of relevant transactions satisfies the arm's length principle, and thus result in taxation in accordance with the provisions of a DTA, South Africa is guided by the OECD Transfer Pricing Guidelines and the United Nations Practical Manual on Transfer Pricing for Developing Countries.
- 11.6. A person can pursue the MAP and domestic legal remedies (see paragraph 9 Dispute Resolution above) simultaneously. SARS may concurrently consider a case presented to the competent authority for MAP and the objection lodged by the taxpayer under domestic tax provisions against the assessment. Depending on the circumstances, the competent authorities may defer the MAP until a decision has been reached on the objection or if a taxpayer has requested a settlement.
- 11.7. MAP does not automatically suspend the payment of taxes. Therefore, it is advisable that taxpayers lodge an objection or appeal concurrently with the MAP process.
- 11.8. South Africa has not committed to MAP arbitration under BEPS Action 14 and the majority of South Africa's DTAs do not contain this provision. A MAP arbitration provision is included in the DTAs with Canada (1997), Netherlands (2008) and Switzerland (2009).

12. Advance Pricing Agreements (APAs)

- 12.1. South Africa currently does not have an APA programme due to the scarcity of resources. However, The South African Revenue Service Strategic Plan 2020/21 – 2024/25 states as its "Strategic objective 1: Provide clarity and certainty for taxpayers and traders of their obligations" that "... *Taxpayers and traders proactively receive clarity guidance, and where required, have easily accessible additional customised support. Certain segments of taxpayers and traders may also access leverage products such as advance pricing agreements, advance rulings (inclusive of VAT rulings and Binding General Rulings) and cooperative compliance programmes.*"

13. Conclusion

- 13.1. Owing to the rapid evolution in the international tax landscape and the change in the mode of doing business by South African multinationals, South Africa continues to explore new

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ways of protecting its tax base through participation in international fora (such as the OECD, ATAF and the UN).

- 13.2. This evolution has brought about substantial changes to South Africa's transfer pricing legislation through incorporation of some of the international best practices and international guidance that has allowed South Africa to be on par with international standards.

D.4. MEXICO COUNTRY PRACTICE

D.4.1. Introduction

D.4.1.1. Mexico introduced transfer pricing rules in 1997 by including the arm's length principle in the Mexican Income Tax Law (MITL). Since fiscal year 2014, the transfer pricing rules are found in Articles 76-IX, 76-X, 76-XII, 110-X, 110-XI, 179, 180, 181 and 182; and regulate both cross-border and domestic intercompany transactions. The Transfer Pricing Guidelines for Multinational Companies and Tax Administrations as approved by the Council of the OECD are referred to as applicable in the MITL, for interpretation of the provisions in transfer pricing matters, to the extent that said guidelines are consistent with the provisions of the MITL and the treaties entered into by Mexico. The transfer pricing regulations are complemented by rules on their application by taxpayers regarding transfer pricing adjustments, interpretation criteria (e.g. comparability adjustments and interviews during APA processes) and undue fiscal practices (e.g. identification of unique and valuable contributions in comparability analysis).

D.4.1.2. In 2016, Article 76-A was incorporated in the MITL, mandating taxpayers to submit the following annual informative returns: (i) master file, (ii) local file and (iii) country by country report.

D.4.1.3. Tax audits in Mexico may be conducted through on-site inspection of taxpayers to review their accounting, goods and merchandise, or through desk reviews, in which the tax authorities may require that taxpayers submit their accounting records, data and other required documents and information at the offices of the tax authorities. In practice, most of the transfer pricing audits are conducted through desk reviews. In certain cases, Mexican taxpayers may receive a non-binding "invitation letter" sent by the Mexican Tax Authorities, raising questions as to specific risk indicators that could cause concerns to the risk assessment department, which has contributed in taxpayers solving tax issues before performing a tax audit or in rejecting preliminary candidates for further review.

D.4.2. Related Party Definition

D.4.2.1. In Mexico two or more individuals or legal entities are deemed as related parties when one of them has a direct or indirect participation in the management, control, or capital of the other, or when a person or a group of persons participate directly or indirectly in the management, control, or capital of such persons. There is no specific threshold for the entities to be considered related parties.

D.4.2.2. In addition, since 2002 members of joint ventures, as well as permanent establishments with regard to their central office or other permanent establishments, are considered related parties. This is in accordance with the provisions of Article 179 of the MITL.

D.4.3. Deemed Related Party Definition

D.4.3.1. It is assumed that any transaction performed with companies that are resident for tax purposes in preferential tax regimes (low or no income tax) will be considered to be carried out between related companies at values other than arm's length. In addition, it is established that the payments made to residents in such regimes are not deductible unless it can be proven that the price or consideration amount was at arm's length.

D.4.4. Specific Documentation Requirements

D.4.4.1. The law in force requires all taxpayers to prepare and keep documentation that proves that all the transactions carried out with related parties are conducted pursuant to the arm's length principle. The transfer pricing documentation must be prepared for each tax year and should have an evaluation per type of transaction and per related party.

D.4.4.2. In addition, certain taxpayers (e.g. large taxpayers) must also disclose information regarding the conclusions of the transfer pricing documentation as part of the appendixes of the statutory tax audit report, or the informative statutory report (ISSIF), along with the sign-off of the expert who prepared the referred documentation. The transfer pricing documentation must contain the following specific requirements:

- (1) Name or firm name of the related company residing abroad, tax address and jurisdiction;
- (2) Documentation that shows the direct or indirect participation among related parties
- (3) Information regarding assets, functions and risks per type of transaction;
- (4) Information and documentation with the detail of each transaction performed with related parties and their amounts per type of transaction; and
- (5) Transfer pricing method applied, as well as the documentation of comparable companies or transactions per type of transaction. An interquartile range of the results obtained from comparable transactions/companies must be used.

D.4.4.3. Taxpayers whose income for the immediately preceding tax year was under 13 million pesos for business activities, or 3 million for the provision of services, have no obligation to prepare and keep the documentation referred to in the law. This benefit does not apply in the case of transactions with companies residing in preferential tax regimes (low or no income tax), contractors or assignees under the terms of the Hydrocarbons Revenue Law, or in the case of having to prepare the transfer pricing informative return (Article 76-X of the MITL).

D.4.4.4. Such documentation should be recorded in account books, specifying that the transactions were performed with related parties residing abroad.

D.4.4.5. The MITL in force establishes that when using financial information to demonstrate that inter-company transactions were performed at arm's length, taxpayers must prepare such information in accordance with the accounting standard in order to calculate the income, cost, gross profit, net income, expenses and operating profit, as well as assets and liabilities.

D.4.4.6. Through an informative return (DIM Annex 9), taxpayers are also required to submit information regarding transactions with foreign-resident related parties. Said information includes among other data, a summary of the intercompany transactions results, elements of the

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economic analysis and the arm's length ranges. The non-compliance with the submission of this informative return results in penalties for the taxpayer.

D.4.4.7. In addition, companies that are required to file a statutory tax audit report (due on June 30) must also submit the following appendices with regard to transfer pricing:

- (1) Type and amount of intragroup transactions by related party, transfer pricing method used, whether the intragroup transaction is at arm's length, and amount of the adjustment if so applied to comply with the arm's length principle;
- (2) Taxpayer's business activity, ownership of intangible assets used, date on which the informative return was submitted and whether the taxpayer has supporting documentation of the arm's length nature of intragroup transactions, advance pricing agreements (APAs) under negotiation, Tax ID of transfer pricing advisors, interest deemed to be dividends, pro rata expenses, financial derivative transactions with related parties, thin capitalization, corresponding adjustments, whether the taxpayer must submit the master file, local file or country by country report; and
- (3) The external auditors of the Mexican taxpayer filing the statutory tax audit report will also have to complete a transfer pricing questionnaire confirming that all transactions were performed at arm's length and the documentation requirements that were met.

D.4.4.8. The documentation substantiating transfer pricing matters must be prepared every year no later than the date when the annual tax return is filed. In the case of an informative tax return, it must be filed not later than the date when the statutory tax report is filed.

D.4.4.9. The Mexican tax authorities conduct audits based on information provided by the taxpayer and other data, including information obtained from:

- (1) Commercial databases, and
- (2) Exchange of information mechanisms with treaty partners.

A key issue is that this information must be consistent and verifiable for purposes of the review.

D.4.4.10. Failing to keep documentary support will result in the external auditor's mentioning of such failure in his report and, in case of an audit, the authority may determine the method and comparable companies it deems appropriate in the application of the arm's length principle, and an adjustment to the income or deductions may be determined. This may result in a new taxable basis and consequently in a new tax charge including inflation, surcharges and penalties, in addition to the potential double taxation resulting from the payment made in the other country. The fine shall range from 55 to 75 per cent of the historical omitted tax (first and penultimate paragraphs of Article 76 of the Federal Tax Code), in the case of improper tax loss, the penalty shall range from 30 to 40 per cent of the difference between the filed tax loss and the loss actually incurred, both of these penalties can be reduced 50 per cent if the transfer pricing study requirement has been met (eight and penultimate paragraphs of Article 76 of the Federal Tax Code).

D.4.4.11. Article 76-A of the MITL establishes the general contents of the master file, local file and country by country report, and which taxpayers must file such annual informative returns. Submission of master file, local file and country by country report is regulated in Article 76-A and miscellaneous tax rules 3.9.11 through 3.9.17. Within this context, there is a penalty in case

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of failing to file the (i) master file, (ii) local file and (iii) country by country report, or submitting them incomplete, with mistakes, inconsistencies or differently from what is indicated in the tax provisions, the penalty shall range from MXN \$154,800.00 to MXN \$220,400.00, and is annually updated according to inflation.

D.4.5. Comparability

D.4.5.1. The following comparability factors are included in the MITL for purposes of the application of the arm's length principle:

- (1) The characteristics of the goods and services;
- (2) The functional analysis;
- (3) The contractual terms;
- (4) The economic circumstances; and
- (5) The business strategies.

D.4.5.2. The MITL establishes the possibility of applying reasonable adjustments to eliminate differences between the comparable transactions or companies. Such adjustments must consider the aforementioned comparability factors. The application of this comparability adjustment follows the arm's length principle, and can be implemented, for instance, as a capital adjustment.

D.4.5.3. Public financial information for local comparables is limited in Mexico. Therefore, taxpayers may use adjusted foreign comparable data, as long as said adjustments are reasonable.

D.4.5.4. Under Article 69 of the Federal Tax Code (Código Fiscal de la Federación or FFC), the Mexican Tax Authority may use confidential information obtained from third parties to determine revenues and deductions of taxpayers that have not performed their transactions at arm's length.

D.4.5.5. Once the comparability factors are considered, the transfer pricing method must be applied which, under the facts and circumstances, provides reliable results. The six methods established in Article 180 of the MITL are basically the same methods included in the OECD Transfer Pricing Guidelines:

- (1) Comparable Uncontrolled Price Method;
- (2) Resale Price Method;
- (3) Cost Plus Method;
- (4) Profit Split Method;
- (5) Residual Profit Split Method; and
- (6) Transactional Net Margin Method.

D.4.5.6. In 2006, resulting from a recommendation from the OECD (as part of the Peer Review of the Mexican Transfer Pricing Legislation and Practices of March 2003), the MITL introduced a hierarchy for the application of transfer pricing methods. In particular, Article 180 of the MITL establishes that taxpayers may use another method only when the CUP Method as outlined in the OECD Transfer Pricing Guidelines is not appropriate to determine the arm's length nature of the tested transaction. The taxpayer must demonstrate that the method used is the most appropriate

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or most reliable pursuant to all available information, giving preference to the Resale Price or Cost Plus Method over the Profit Split or Transactional Net Margin Methods.

D.4.5.7. To determine the price that should be used between independent parties, Article 180 of the MITL allows the use of a range of prices or profit margins resulting from the application of a method with two or more comparable transactions. Such range may be adjusted through statistical methods (specifically the interquartile range).

D.4.5.8. The MITL accepts multiple year data only for comparables, and provided that taxpayers must demonstrate that the business cycle or the commercial acceptance of the products cover more than one year. The MITL does not allow the use of multiple years if this is only applied as a statistical tool to mitigate changes and trends in the financial indicators of the comparables.

D.4.5.9. The MITL transfer pricing rules for inter-company financing focus on the characteristics to consider in applying proper comparability factors with uncontrolled transactions. These characteristics include the principal amount, payment period, guarantees, debtor's solvency and interest rate.

D.4.5.10. Payments made abroad for interest paid to related parties may be deemed as dividends if they arise from an unconditional promise of payment agreement involving the total or partial payment of credit received, of standby credit, or of a profit-related payment condition; or from the management of the business.

D.4.5.11. Thin capitalization rules are established in Article 28, Section XXVII of the MITL, which states that the interest paid to related parties will not be deductible in amounts exceeding the 3:1 ratio of liabilities to the equity of the company. The rule does not apply to entities that are part of the financial system (as defined in the MITL) and those taxpayers that assumed for the construction, operation or maintenance of productive infrastructure related to strategic areas of the country or electric power generation. Other exemptions and waivers regarding thin capitalization rules may apply. For example, taxpayers who obtain an APA for inter-company loan transactions are not subject to this limitation.

D.4.5.12. In the case of transactions related to the sale or purchase of stocks, the taxpayer must consider elements such as: (i) the equity value of the issuer's stockholders as of the transaction date; (ii) the present value of its profits or cash flows; or (iii) the last published market price of the stock.

D.4.6. Audit Procedure

D.4.6.1. In Mexico, taxpayers must allow inspections to verify tax compliance and provide all documentation requested by the tax authorities. If the tax authorities considers that the taxpayer has not complied with its obligations adequately, the taxpayer must provide all evidence demonstrating such compliance.

D.4.6.2. The burden of proof resides with the taxpayer, who must prepare transfer pricing documentation to demonstrate that its intercompany transactions were performed at arm's length. If the tax authorities review this information and find that the taxpayer is not in compliance, the tax authorities are liable to determine arm's length prices, considering the information available or otherwise identified for such purposes. If the dispute goes to the tax court, the taxpayer and the

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tax authorities must present all evidence they deem appropriate to defend their respective positions.

D.4.6.3. Currently, different audit units of the Large Taxpayers Division of the Mexican Tax Administration conduct audits with a holistic approach, which includes transfer pricing along with other taxes such as VAT, withholding taxes, customs and other local tax provisions, with the coordination and advice of the Transfer Pricing unit.

D.4.6.4. One of the objectives of this audit programme is to focus revisions on the most recent tax years and, if possible, in real time, taking advantage of recently assembled information, experienced staff and resources to streamline the capacity of the tax administration to address tax issues and ensure that the business operations of the taxpayers are in compliance with the tax regime. The tax administration can also monitor the performance of the taxpayers in the post-audit stage and for more recent tax years it is much easier to understand and outline a value chain analysis of the business for a better resolution of the case.

D.4.6.5. Mexico has a cooperative compliance programme whereby based on principles of trust, transparency and mutual understanding the tax administration looks to improve voluntary compliance by taxpayers with their tax obligations. Applying an objective interpretative (“substance over form”) criterion, which would facilitate and simplify the application of tax provisions, the tax administration aims to establish effective long-term, trustful relationships with taxpayers to identify risk areas and use its resources and capacity to find a successful solution. This programme is in line with international best practices.

D.4.6.6. Owing to the significant increase of audits (including transfer pricing) and the increase in tax controversies, and the long process for resolving disputes in tax courts, coupled with the high cost thereof, the Conclusive Agreement was created as an alternative for solving controversies during the audit process without the need of recurring to appeals or litigation. This mediation process can be considered as a domestic supplementary dispute mechanism that allows tax authorities and taxpayers alike to cope with the complexities of tax (including transfer pricing) disputes by providing the chance to solve the controversy at the audit stage.

D.4.6.7. The Conclusive Agreements are handled by the Tax Ombudsman Agency (Prodecon), that acts as an independent impartial official mediator between the taxpayer and the tax authorities.

D.4.6.8. The mediation begins with the request of the taxpayer which must contain the reasons for his dissent and the tax treatment that he believes should apply to the findings detected by the authority during the tax audit, accompanied of all the necessary documentation supporting his position. The filing of the Conclusive Agreement suspends legal deadlines, including the audit and collection procedures, which allows the parties to discuss and analyse the controversy in a detailed manner with no time constraints. However, the Conclusive Agreement is an effective and efficient mechanism when the taxpayer is aware of adjustments that must be performed to his tax position; for cases where the taxpayer is convinced that his tax position is correct it might represent an extended and inefficient use of resources.

D.4.6.9. The core of the mediation is the tax treatment that the tax administration is giving to the tax situation detected during an audit and can involve aspects related to the interpretation of the law, formal issues and/or assessment of evidence presented during the audit, as well as relieving associated penalties if the agreement is reached.

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D.4.6.10. No tax debts are addressed during the mediation, since the procedure can only be initiated during the audit but not after the tax authority has issued a tax assessment. This encourages consensus since discussions between the parties take place before there is a final decision of the tax authority.

D.4.6.11. This procedure is optional for the taxpayer but it is mandatory for the tax authority to attend the mediation. However, as it is common in most alternative dispute resolution procedures, it is optional for the tax authority to finally accept or refuse the proposals to reach a solution to the dispute.

D.4.6.12. Meetings with the taxpayer and tax authorities can be set to discuss the specific tax controversy. The meetings are held in a neutral environment that encourages addressing technical issues through the exchange of points of view and documentation regarding tax law, accounting issues or tax specific situations, with the input and active participation of the representatives of Prodecon.

D.4.6.13. Once the Conclusive Agreement is signed, the tax effects agreed therein apply immediately and the tax audit is definitively closed. The parties are legally unable to challenge the result of a Conclusive Agreement by any domestic mean or modify the results of the agreement through negotiation in a MAP. Additionally, according to the Federal Tax Code, the Conclusive Agreement creates no legal precedent, which provides certainty to the tax authority that any agreed issues cannot be raised in a different or new tax controversy.

D.4.6.14. If no agreement is reached between the tax authority and the taxpayer the suspension of the audit concludes and all legal procedures are continued (i.e. by the issuance of a tax assessment). In this case, the taxpayer will still be able to file the corresponding legal defense, i.e. administrative appeal or tax litigation against the tax assessment.

D.4.7. Advance Pricing Agreements (APA) Procedures

D.4.7.1. Article 34-A of the Federal Tax Code enables taxpayers to submit unilateral, bilateral or multilateral APA requests. Unilateral APAs may cover the tax year of submission, the preceding tax year and the following three tax years. APAs may be valid for a longer period if an agreement is reached with the competent authority (authorities) of the Contacting State(s) under a Convention to which Mexico is party.

D.4.8. Maquila Export Companies

D.4.8.1. The Maquiladora Program started in the late 1960s as a direct response to the cancellation of the US Bracero Program that had allowed temporary Mexican migrant agricultural workers into the United States for seasonal employment. The Mexican and United States Governments agreed to the maquiladora programme whose immediate purpose was to provide employment in Mexico and generate economic activity in the manufacturing industry. It was not originally envisaged for taxation purposes, multilateral trade treaties or long-term foreign direct investment.

D.4.8.2. In 1989 the Mexican Government issued a decree to adapt and expand the maquiladora programme, with the intention of moving beyond simple job creation into a more meaningful economic development of the Mexican manufacturing and export generation base. The expansion

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programme was intended to develop a local supply chain for US manufacturers and to include a qualification programme (PITEX Program) for Mexican companies to produce and supply some of the inputs for the US companies (unlike maquiladoras that import all inputs).

D.4.8.3. A maquiladora is a Mexican subsidiary company, usually 100 per cent foreign-owned, whose primary role is assembly. Maquiladoras are defined in the Presidential Decree (Decreets for the Fostering and Operation of the Maquiladora Industry for Export) as assembly plants undertaking maquiladora activities under a permit issued by the Ministry of Economy.

D.4.8.4. Maquiladoras are usually structured as cost centres, with marginal profits. Their activities include the maintenance of assets and inventories provided by foreign residents for their transformation (production, sub-assembly and assembly) into semi-finished and finished goods destined for export (mainly for the United States market). Typically, foreign parent companies own inventories, equipment and machinery, provide the maquiladora with all the input, technology and know-how to carry out the manufacturing process, and allow the maquiladora the use of patents and technical assistance free of charge. Maquiladoras usually own or lease few assets, including a physical facility in Mexico; they hire and manage the labour pool required, and use capital free loaned by the parent company to transform inputs into products for export to the parent company or another related party. Many maquiladoras actually perform some additional functions for the parent company that must be identified and pay taxes apart from the maquiladora services. However, maquiladoras are generally treated as “contract” companies since it is considered that they perform functions requiring no valuable intangibles and very few routine intangibles.

D.4.8.5. Parties residing abroad may constitute a permanent establishment in Mexico arising from the legal or economic relations with Maquila export companies.

D.4.9. Current Maquila Provisions

D.4.9.1. Entities carrying out maquila operations will comply with the arm’s length principle, and it will not be considered that the foreign residents for which the maquila operates will have a PE regarding the foreign assets being used if the maquiladoras determine their taxable profit according to “safe harbour” rules. Under this measure, the Maquila companies have to obtain a taxable profit that represents at least the larger of the values of:

- (1) 6.9 per cent on the assets used in the Maquila activity, both its own and those of the party residing abroad, or
- (2) 6.5 per cent on the costs and expenses incurred by the Maquila company.

D.4.9.2. This option has remained the same since the year 2000. For purposes of this option, the obligation to the Tax Administration Service (SAT) is to file an informative return stating that the taxable profit obtained represents at least the greater amount resulting from applying the 6.9 per cent or 6.5 per cent calculations as referred to above, corresponding to the safe harbour option.

D.4.9.3. These rules include several provisions for existing and newly organized maquiladoras with respect to the determination and valuation of the asset base and cost base (i.e. adjustments for inflation, amortization, inventory and currency conversion; exclusion for shelter activities, time frames, documentation requirements, conditions for changing options etc.).

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D.4.9.4. Also, the entity resident in Mexico can submit an APA application to confirm compliance with the arm's length principle, and that foreign residents would not constitute a PE. The APA must be requested under the rules of Article 34-A of the Federal Tax Code.

D.4.9.5. Regarding the APA maquila program, since the vast majority of cases dealt with US principals, in 2016 the Mexican tax authorities and the United States Internal Revenue Service (IRS) reached a technical agreement and established administrative measures so that U.S. taxpayers with maquiladora operations in Mexico will not be exposed to double taxation if they enter into a unilateral APA with Mexico, under terms agreed in advance between the U.S. and Mexican competent authorities.

D.4.9.6. The agreement between the competent authorities provides the Mexican Tax Authority the approach to be followed for qualifying taxpayers that have requested a unilateral APA. These taxpayers may apply a transfer pricing framework that the U.S. and Mexican competent authorities have agreed in advance will produce arm's length results.

D.4.10. Competent Authority Procedure

D.4.10.1. Determinations done by the tax authority of a jurisdiction regarding the compliance with the arm's length principle that represent a modification of revenues or deductions of a Mexican taxpayer may be performed solely by filing an amended tax return, providing that the SAT has accepted such adjustment, validated through a competent authority procedure under the tax treaty in place.

D.4.10.2. The tax authorities may totally or partially condone the surcharges resulting from an adjustment to prices or to consideration amounts in the case of transactions between related parties, provided that said condoning arises from an agreement with a competent authority, based on reciprocity, between the competent authorities of Mexico and those of a country with which Mexico has entered into a double tax convention, and provided that said authorities have refunded the corresponding tax without the payment of any amounts corresponding to interest.

D.4.11. Effective Implementation of the Arm's Length Standard

D.4.11.1. The main pillars of an effective implementation of the arm's length standard are comprehensive legislation, trained and adequate personnel, control procedures and a robust, systematic and precise risk assessment system.

D.4.11.2. Mexico recognizes that a well-founded risk assessment system is the correct starting point of an effective tax audit cycle, and in this regard a series of tax structures and arrangements have been identified by the Mexican Tax Administration and tackled by implementing specific audit programmes. This relates to the causes and effects of eroding structures, which from a transfer pricing perspective have an impact on operating results, net results and tax results of non-reported inter-company income, involving base eroding payments (including those settled with low-tax jurisdictions or with no economic sense, such as royalties, interests, intragroup services, among others) and business restructurings (assets and risk reallocations).

D.4.11.3. It has been recurrently noted by Mexican tax officials that intragroup service transactions are a risk area, and in 1981 the Mexican Income Tax Law was reformed to include a limitation of the deduction of prorated expenses. Nonetheless in 2014, the Mexican Supreme

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Court ruled that the limitation of the deduction of prorated expenses is neither absolute nor unrestricted, thus the deduction may be permitted if certain conditions are fulfilled, namely that the service transaction has been rendered, that it provides a benefit to the recipient and that it conforms to the arm's length principle.

D.4.11.4. Information asymmetry is a critical issue in effectively documenting an intragroup service transaction so it is crucial that taxpayers provide appropriate information on the service rendered, the service provider entity (even if it is a foreign entity), and the benefit test. It would also be useful to make a general assessment of the financial status of the service recipient entity, which must have the financial capacity to bear the expense; and it has been important to clarify to taxpayers in Mexico that in the absence of the appropriate information that demonstrates an intragroup service transaction the expenses can be non-deductible under the Income Tax Law.

D.4.11.5. Royalties paid by a taxpayer to nonresident related parties for the temporary use of intangible assets are likely to be challenged when such royalties are from a Mexican source and were previously owned by such taxpayer or any related party thereof residing in Mexico, when the transfer of the intangible assets was made without receiving any consideration or at a non-arm's length price.

D.4.11.6. The SAT has challenged the fact pattern where there are advertising and marketing expenses incurred by Mexican subsidiaries along with royalties paid to their related parties abroad for marketing intangibles, since the legitimate owners of the intangibles surplus are the ones creating them. These are mostly the entities in charge of the development of brand awareness, brand positioning, and brand prestige adding value to the business cycle.

D.4.11.7. Mexican subsidiaries should be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles.

D.4.11.8. Two of the key components of the aforementioned transactions are the economic valuation of the intangible assets and the amount of the royalty payments arising from the use of such assets. Both elements should be analysed under the tax regulations on transfer pricing in force since 1997.

D.4.11.9. In Mexico, as in many countries, taxpayers tend to over-utilize net margin TP methods to support the Mexican taxpayer's financial results (regardless of a careful review in establishing the tested party), collecting external comparables operating in the same industry from commercial databases, mostly from developed countries such as United States and Canada, since public data from local comparables is scarce due to the low market capitalization in Mexico. Since in most industries the macroeconomic conditions between Mexico and developed countries such as the United States and Canada differ, it is necessary to perform comparability adjustments to the financial results of the comparables.

D.4.11.10. The application of a comparability adjustment follows the arm's length principle, and this can be implemented as a capital adjustment taking into account the inherent differences between the sovereign bond yields of the two countries—the country of residence of the tested party and the country of residence of the comparable—and applying it as a factor in the invested capital or operating assets of the companies. Even though a country risk adjustment would generally improve the comparability of the companies in this situation, there can be specific

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industrial differences among countries which must be evaluated independently. Another separate comparability adjustment may come from local saving advantages.

D.4.11.11. An aggressive tax planning structure found in Mexico relates to full manufacturing companies performing all productive processes from purchase of raw materials, manufacturing the products, product development and incorporation of intangibles, searching for clients, selling the finished products to the clients, and assuming all related risks in the Mexican market; and suddenly the manufacturing activities turn into maquila services and presumably acts as a limited risk entity only receiving compensation through a mark-up over salaries, and a minimal commission for the sales to the retailers, despite having the same functions as before the reorganization.

D.4.11.12. These reorganizations are being challenged following the 2014 tax reform under which maquila companies must export all of the products they produce, and if the products are found to be sold in Mexico, the value chain, even if fragmented, would be assessed and taxed in its entirety in Mexico, including the manufacturing and distribution portions of the business performed in Mexico.

D.4.12. Recent Developments

D.4.12.1. The SAT is committed to implementing the Base Erosion and Profit Shifting (BEPS) initiatives. Within this context, the 2020 tax reform (in effect for fiscal year 2021) establishes the implementation of Action 4 (Limitation on Interest Deductions; establishing a limit of 30% of EBITDA, contained in Article 28 – XXXII of the MITL).

D.4.12.2. In addition, the above mentioned tax reform also implemented Action 12 (Mandatory Disclosure Rules) through Articles 197 – 202 of the Federal Tax Code. Regarding Mandatory Disclosure Rules, the transfer pricing-related schemes that must be disclosed contemplate the following:

- Transmission of Hard to Value Intangibles;
- Business restructurings;
- Non-remunerated services or functions, as well as non-compensated transmission of goods and rights;
- Transactions for which there are no reliable comparables; and
- Application of foreign safe harbours.

Foreword to the Third Edition (2021)

PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES

This third edition of the United Nations Practical Manual on Transfer Pricing for Developing Countries (the Manual) is intended to draw upon the experience of the first edition (2013) and the second edition (2017) including feedback on the latter version, but it is also intended to reflect developments in the area of transfer pricing analysis and administration since that time.

During the 15th session of the UN Committee of Experts on International Cooperation in Tax Matters (“the Committee”) in 2017 a new Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing (“the Subcommittee”) was formed, to be Co-Coordinated by Ingela Willfors and Stig Sollund, with the following mandate:

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

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

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

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

ATTACHMENT E – FOREWORD TO THE THIRD EDITION

As proposed by the Subcommittee at the 17th Session and approved by the Committee, this third edition of the Manual, makes 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. Improved capacity development based on the Manual has encouraged and contextualized developing country feedback, helped identify these priority areas for improvement and contributed to better targeting the messages in the Manual and examples used.

The Forewords to the first two editions of this Manual, which are retained in the following pages, remain relevant as to their substance. In particular, the recognition in the foreword to the First Edition that:

“While consensus has been sought as far as possible, it was considered most in accord with a practical manual to include some elements where consensus could not be reached, and it follows that specific views expressed in this Manual should not be ascribed to any particular persons involved in its drafting. [Part D] is different from other chapters in its conception, however. It represents an outline of particular country administrative practices as described in some detail by representatives from those countries, and it was not considered feasible or appropriate to seek a consensus on how such country practices were described. [Part D] should be read with that difference in mind.”

As with the Subcommittees involved in drafting the earlier editions of this Manual, the current Subcommittee is comprised of Members from tax administrations with wide and varied experience in dealing with transfer pricing as well as those from academia, international organizations and the private sector, including from multinational enterprises and advisers. The Subcommittee met successfully on many occasions: New York (February 2018 and May 2018); Quito (October 2018); Vienna University of Economics and Business (February 2019 and February 2020); IBFD, Amsterdam (July 2019); Nairobi (December 2019). Short meetings were also held in the side-lines of some Committee sessions. The generosity of country and institutional hosts of Subcommittee meetings is warmly acknowledged, as is the support of the European Commission for some of these meetings and of the Norwegian Government in this and other Committee projects.

The members of the Subcommittee and their countries (in the case of government officials) or current affiliations (in other cases) contributing to this updated version of the Manual at various times, were, bearing in mind that membership is assumed on a personal capacity: Ingela Willfors (Sweden—Co-Coordinator); Stig Sollund (Norway—Co-Coordinator); Joseph Andrus (independent consultant); Rajat Bansal (India); Melinda Brown (OECD); Hafiz Choudhury (The M Group); Sanya Gbonjubola (Nigeria); Stefan Greil (Germany); Andrew Hickman (independent consultant); Mitsuhiro Honda (University of Tsukuba, Japan); Michael Kobetsky (Australian National University and Melbourne University, Australia); Michael McDonald (EY, USA); Toshio Miyatake (Adachi, Henderson, Miyatake and Fujita, Japan); George Obell (Kenya); Emily Muyaa (IBFD); T.P. Ostwal (TP Ostwal & Associates, India); Raffaele Petruzzi (Vienna University of Economics and Business, Austria); Christoph Schelling (Switzerland); Jolanda Schenk (Shell, Netherlands); Carlos Perez-Gomez Serrano (Royalty Range, Mexico); Caroline Silberztein (Baker & McKenzie, France); Monique van Herksen (Simmons & Simmons, Netherlands); Jose Ignacio

ATTACHMENT E – FOREWORD TO THE THIRD EDITION

Troya Gonzalez (Ecuador); Marcos Valadão (Catholic University of Brasilia, Brazil); Xiaoyue Wang (KPMG, China); Sing Yuan Yong (Singapore); and Ying Zhang (China). The assistance to the Subcommittee is also acknowledged of Marc Bochsler and Basil Peyer (both from Switzerland).

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