TRANSFER PRICING
Rules & Practice

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Foreword

It is our distinct pleasure to welcome you to the wonderful world of transfer pricing. In our world, rules and practices change at lightning speed. Financial models are affected while disputes are fought out both in court and in the newspapers.

This book will act as an easy access point for you to explore this wonderful world. In fact, it is the only book on the market that looks at transfer pricing from a practical perspective. Instead of drowning you in technical jargon, we prepare you for the trenches of the modern transfer pricing practice. We discuss the most important rules, a wide variety of examples and case studies drawn from our own experience as transfer pricing professionals.

Once you’ve finished reading the book, you will have a solid understanding of all the essential transfer pricing rules and practices for the field. Dealing with transfer pricing matters will become a breeze!

We trust you will enjoy the read!
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\(^1\) WIPO, “Berne Convention for the Protection of Literary and Artistic Works,” (Berne, September 9, 1886)
Introduction of the Authors

Wesley Thysse Msc.

Wesley is a transfer pricing expert with more than nine years of professional working experience in Europe and Asia. Wesley started his career in finance. He worked as a project controller at Multi Real Estate, a large developer of iconic shopping malls in Europe. He later settled in Dubai where, as a corporate service provider, he assisted entrepreneurs and high-net-worth individuals with international tax planning and legal structuring. In 2014, he moved to Asia. As an independent consultant, he has since helped 100’s of SME’s and HNW-individuals with international tax and transfer pricing issues. In 2016, he started the website “Transfer Pricing Asia” to serve the region. It is now visited by more than 5,000 finance and tax professionals per month. Wesley holds a Msc. degree in Management from the University of Greenwich, London.

Martijn de Lange LL.M. (hons)

Martijn is a transfer pricing expert with more than ten years of professional experience working in Europe and Asia. Martijn started his career at Deloitte. He then obtained a position as a tax lawyer at Loyens & Loeff, a renowned tax law firm, and worked in their Dutch and Hong Kong offices. While there, he successfully expanded the firm’s transfer pricing practice in both the Netherlands and Asia. He continued his career as an in-house tax professional for a listed multinational, assuming responsibility for tax matters in the Asian region. Martijn often lectures and publishes on transfer pricing. His key accomplishments include:

• Development of a two-day course called: “Dealing with Transfer Pricing in Asia” that he presented to senior professionals and government regulators in both Manila and Hong Kong
• Speaker at the IFA Asia-Pacific Regional Tax Conference (Singapore)
• Speaker at the UIA Congress (Macau)
• Contributor to numerous articles in publications such as the Asia-Pacific Tax Bulletin, International TP Journal and BNA.

Martijn holds degrees in Tax Law (hons) and Corporate Law from Leiden University in The Netherlands.
Summary of Chapters

Before we dive into transfer pricing, we first have to define it. Chapter 1 looks at definitions used by international organizations. It then provides a simple definition for the remainder of this book. Afterwards, it examines certain key concepts in the field including Associated Enterprises, Controlled Transactions and the Arm's Length Principle.

Chapter 2 describes why transfer pricing is such a hot topic. In fact, a major share of international trade consists of controlled transactions. Moreover, transfer pricing is a key driver for the tax bill of MNEs. Using a detailed example, we demonstrate how transfer pricing practices can lead to “profit shifting” and “erosion of the tax-base.” We then discuss the attention being paid to transfer pricing by politicians, lobby groups and the media, and how it contributed to the world-wide implementation of (broadly similar) transfer pricing legislation. Finally, we look at the consequences of not following transfer pricing rules.

After wrapping up the theoretical foundation, we then start to look the more practical aspects of the field. First of all: how to perform a transfer pricing analysis. Chapter 3 introduces a “Nine-Step Process” for discovering the correct transfer price for a controlled transaction. It reveals where you can find internal and external prices for your benchmark – and how to correctly analyze this data.

An essential part of your transfer pricing analysis is choosing the right transfer pricing method. Chapter 4 examines the five common methods for doing this, providing detailed examples of their usage. You'll find out which method suits each situation, as well as gain insight on a simple tool that can help substantiate any decision-making.

After concluding your transfer pricing analysis and selecting the correct method, it's time to wrap it all up in solid documentation. Chapter 5 introduces “Seven Building Blocks” to build transfer pricing documentation from scratch. It is also points out what other types of general transfer pricing documentation you’re expected to create.

One essential aspect of transfer pricing regulation is to ensure the use of the correct prices within MNEs. Chapter 6 spells out how to create a transfer pricing policy and integrate this in the day-to-day practice of a MNE, as well as overcome practical hurdles for doing so. Lastly, it includes drafting suggestions for transfer pricing agreements, given their importance in he defense of a policy.

Disputes with tax authorities are unfortunately increasingly common in the practice of transfer pricing. Chapter 7 discusses the nature of disputes, provides details on common dispute areas, and presents five measures you can take to avoid them.

Annex I includes additional guidance on the creation of a Master File, a Local File and a Country-by-Country Report.
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Afterword
Chapter 1 – What Is Transfer Pricing?

In 2010, few people knew much about transfer pricing. Most tax advisors disregarded the discipline. But how this has changed! Within just eight years, transfer pricing has become a large part of worldwide public debate and legislation. Nowadays, everybody has something to say about it. The media certainly has played a role in this.\(^2\)

The existence of so many opinions sometimes causes confusion about what transfer pricing actually means. Some consider it a harmful practice for tax avoidance and evasion. An infamous quote is: “Transfer pricing is the leading edge of what is wrong with international tax.”\(^3\)

This sentiment is best captured by a quote from Margaret Hodge, a British Labor Party politician, who during a hearing on transfer pricing practices applied by Multi National Enterprises (MNEs) told representatives of Google: “You do evil!”\(^4\)

These notions and opinions have unfortunately clouded the definition of transfer pricing. Before we can continue with this book, we must therefore define transfer pricing and then clarify certain key concepts.

1.1 – Defining Transfer Pricing

How do we define transfer pricing? Luckily, there are various definitions available from reputable sources to do so.

In the Practical Manual on Transfer Pricing for Developing Countries, the United Nations defines the discipline as follows:

Transfer pricing” is the general term for the pricing of cross-border, intra-firm transactions between related parties. Transfer pricing therefore refers to the setting of prices 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 companies that are not associated and can be assumed to operate independently (“on an arm’s length basis”) in setting terms for such transactions.\(^5\)

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\(^3\) Lee Sheppard, Tax Analysts, August 2012


Lobby group Tax Justice Network\(^6\) defines transfer pricing as follows:

Transfer pricing happens whenever two companies that are part of the same multinational group trade with each other: when a US-based subsidiary of Coca-Cola, for example, buys something from a French-based subsidiary of Coca-Cola. When the parties establish a price for the transaction, this is transfer pricing.\(^7\)

In this book we will use the following, simplified, definition:

Transfer prices refer to the terms and conditions which associated enterprises agree for their controlled transactions.

Two key elements embedded in this definition need clarification: “associated enterprises” and “controlled transactions.” We address them below.

1.1.1 – What are Associated Enterprises?

Based on a commonly used definition from the Organization for Economic Co-operation and Development (the OECD)\(^8\), enterprises are associated if:

- A) an enterprise participates directly or indirectly in the management, control or capital of another enterprise or,
- B) the same persons participate directly or indirectly in the management, control or capital of the two enterprises.

Let’s look at some examples to clarify this:

**Example 1 – Associated via board of directors**

MEGA Nigeria owns both 100% of the shares in both MEGA South Africa and MEGA Zimbabwe. MEGA Nigeria, MEGA South Africa and MEGA Zimbabwe are all associated enterprises – see part (A) of the OECD definition, which clearly mentions capital participation.

---

\(^6\) TJN is an advocacy group consisting of a coalition of international researchers and activists with a shared concern about tax avoidance, tax competition, tax evasion, and tax havens.


\(^8\) OECD, “Articles of the model convention with respect to taxes on income and on capital,” (OECD Publishing, Paris, January 28, 2003), available at [http://www.oecd.org/tax/treaties/1914467.pdf](http://www.oecd.org/tax/treaties/1914467.pdf). This definition is based on article 9(1). Please note that article 9 defines when enterprises are associated for the purpose of tax treaty application and the exact wording of that article is (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.
**Example 2 – Associated via shareholders**

Sarah Scooters and Manolo Motors are two separate enterprises with different business activities and different shareholders. However, both enterprises have the same three motorcycle loving brothers on their board of directors. Sarah Scooters and Manny Motors are associated enterprises – see part (B) of the OECD definition, which clearly mentions management participation.

**Example 3 – Associated via indirect control**

Sally is the sole shareholder of an enterprise selling sugar, called Sally Sugar. Sally has the plan to set up an enterprise called Arya Accounting in the British Virgin Islands, a low-tax country, and have this enterprise render accounting and administrative services to Sally Sugar for a fat fee. Arya Accounting will have a nominee director, and will be legally owned by a foundation in Panama. But behind the scenes, Sally plans on running the show. Moreover, she will be the only beneficiary of the foundation. In short: Sally will have full control over Arya Accounting. As a result, Sally Sugar and Arya Accounting are associated enterprises – see part (B) of the OECD definition, which clearly mentions direct and indirect management, control or capital participation.

You may wonder whether direct or indirect participation in management, control or capital is sufficient for qualification as an associated enterprise. Despite the broad OECD definition, the answer is: no. Rather, the relevant criterion is whether there is a sufficient level of participation in which there is “control” over the terms and conditions of transactions between associated enterprises.

**Example 4 – No control**

Let’s say that in Example 2 MEGA Nigeria sold 95% of its shares in MEGA South Africa to an investment bank. In addition, 95% of the shares in MEGA Zimbabwe were sold to a competitor. MEGA Nigeria now owns just 5% of the shares in both enterprises. Although MEGA Nigeria still participates in the capital of both enterprises, it is unlikely that it can control the terms and conditions of any controlled transaction between these enterprises. The third parties owning 95% of the shares would of course not accept non-market terms and conditions if it is not in their interest to do so!

To tackle the issue of whether enterprises are associated or not, domestic transfer pricing rules often include certain thresholds that must be met. For example, in China enterprises are only associated if a shareholder has a direct or indirect capital participation of at least 25%. Evaluating domestic transfer pricing rules should therefore be your primary objective when analyzing whether enterprises are associated or not.
1.1.2 – What are Controlled Transactions?

Controlled transactions are transactions between two enterprises that are associated enterprises.\(^9\) Transfer pricing refers to the terms and conditions that associated enterprises agree upon for these controlled transactions. When enterprises are associated, and there are no controlled transactions, transfer pricing is not an issue. It is thus critical to understand the difference between “controlled” and “uncontrolled” transactions.

Let’s look at some examples to demonstrate the difference:

**Example 5 – Controlled transaction I**

Funky Global owns 100% of the shares in Funky Fruit. Funky Fruit sells apples to Funky Global. The sale of apples is a **controlled** transaction.

**Example 6 – Controlled transaction II**

Freddy Furniture and Freddy Distribution are both 100% owned by Freddy Holding. Freddy Furniture sells chairs to Freddy Distribution. The sale of chairs is a **controlled** transaction.

**Example 7 – Controlled transaction III**

Mr Koerban is the sole director of both Mike Management and Teddy Trading. Mike Management sells interim management services to Teddy Trading. The sale of management services is a **controlled** transaction.

**Example 8 – Uncontrolled transaction I**

First Financing and Harry Hedgefund are not associated in any way via management, control or capital. First Financing provides a loan to Harry Hedgefund. The provision of the loan is not a controlled transaction. It is an **uncontrolled** transaction.

**Example 9 – Uncontrolled transaction II**

As mentioned in example 5, Funky Global owns 100% of the shares in Funky Fruit. Besides selling apples to Funky Global, Funky Fruit also sells apples to independent enterprise Andy Apples. Since Funky Fruit and Andy Apples are not associated, the sale of apples is an **uncontrolled** transaction.

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1.1.3 – Types of Controlled Transactions

There are many different types of controlled transactions. Below, is a list of fictional examples within Coca Cola:

<table>
<thead>
<tr>
<th>Type of controlled transaction</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supply of goods</td>
<td>Coca Cola US sells two containers of cans of Coke to Coca Cola Mexico.</td>
</tr>
<tr>
<td>Provision of management services</td>
<td>The CEO of Coca Cola, based in its US Headquarters, renders strategic advice to an operating company of Coca Cola Canada.</td>
</tr>
<tr>
<td>Provision of support services</td>
<td>The Shared Service Center of Coca Cola in Manila renders administrative services to Coca Cola Hong Kong and Coca Cola China.</td>
</tr>
<tr>
<td>Granting of license</td>
<td>Coca Cola US, who owns the Coca Cola brand, grants a license to Coca Cola Netherlands to use the brand name in the Netherlands only.</td>
</tr>
<tr>
<td>Transfer of business / assets</td>
<td>Coca Cola Austria transfer its stocks and client list to Coca Cola Germany.</td>
</tr>
<tr>
<td>Provision of loan</td>
<td>Coca Cola Bermuda grants a loan to Coca Cola Mexico to expand the business.</td>
</tr>
</tbody>
</table>

1.1.4 – “Invisible” Controlled Transactions

All the examples provided so far are controlled transactions that are typically easy to identify in the accounts and administration of an enterprise. We call these: “visible” controlled transactions. However, on some occasions, such identification is not so easy. We call these: “invisible” controlled transactions. Let’s look at two examples:

**Example 10 – Group guarantee**

First Financing and Harry Hedgefund are not associated via management, control or capital. First Financing issues a loan of USD 100m to Harry Hedgefund with an interest rate of LIBOR + 2%. Harry Hedgefund was only able to negotiate this rate as Harry Private Equity, an associated enterprise, provided a guarantee to First Financing for repayment of the loan's full amount. Without the guarantee, the rate would have been LIBOR + 4%. The provision of the guarantee is a controlled transaction. Neither Harry Hedgefund nor Harry Private Equity discloses the guarantee in their financial statements as it is not mandatory to do so. It could therefore be difficult for someone not involved in the transaction to recognize it as “controlled.”

**Example 11 – Restructuring**

Bill Bananas is the sole shareholder of two enterprises in Europe: Bill Bananas NL and Bill Bananas UK. Following an internal reorganization, the sales activities of Bill Bananas UK are transferred to Bill Bananas NL, including client lists and marketing know-how. The transfer of the sales activities is therefore a controlled transaction.
There is no agreement for the transfer and no compensation is paid. Neither the books of Bill Bananas NL nor Bill Bananas UK disclose it. Again, it could be difficult for someone not involved in the transaction to recognize it as “controlled.”

1.1.5 – What if there are no Controlled Transactions?

It is worth repeating that, with transfer pricing, you only look at controlled transactions. When enterprises are associated and there are no controlled transactions, transfer pricing does not present any issues.

Example 12 – No transactions

Carla Consulting Russia owns 100% of the shares of two enterprises: Colon Consulting Germany and Kubrat Consulting Bulgaria. These subsidiaries operate completely independently from one another and their shareholder. They have their own management, clients, product lists and brands. They are both profitable, and pay a significant annual dividend to Carla Consulting. However, there are no controlled transactions and thus, no transfer pricing issues.

1.2 – The Arm’s Length Principle

The Arm’s Length Principle (ALP) is another crucial aspect of transfer pricing. Most countries have implemented transfer pricing rules that follow the ALP as a guiding principle. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations\(^{10}\) (the OECD Guidelines) cites Article 9 of the OECD Model Tax Convention as the basis of bilateral tax treaties of member- and often non-member states, and is thus the most authoritative statement on the ALP. According to Article 9:

[where] conditions are made or imposed between the two [associated] 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 those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

In simple terms: enterprises must agree upon terms and conditions for their controlled transactions that are similar to those which would have been agreed upon between independent enterprises.

The critical assumption underpinning the ALP is that independent enterprises always hold each other at arm’s length with their transactions. Whether this assumption is factually correct or not – and in most cases it is – is actually irrelevant for the application of the ALP.

Should the terms and conditions of a controlled transaction meet the ALP, you can say that the transaction happens “at arm’s length.”

Confused? Here’s an example:

**Example 13 – Arm’s Length Principle**

**Transaction #1** – Andy Apples produces apples and sells them to Andy Wholesale. Andy Apples and Andy Wholesale are both fully owned by Andy Holding. The sale of apples is a controlled transaction. The terms and conditions of the transaction should therefore satisfy the arm’s length principle; the terms and conditions should be the same as if they had been agreed upon between independent enterprises.

**Transaction #2** – Freddy Fruit produces the same apples as Andy Apples, and sells these apples to Andy Wholesale. Freddy Fruit and Andy Wholesale are not associated. The sale of apples is an uncontrolled transaction of which the terms and conditions are deemed to be “at arm’s length.”

*If Transaction #1 is concluded under the same terms and conditions as Transaction #2, we could say that the terms and conditions of Transaction #1 are at arm’s length.*

**1.2.1 – Criticism of the Arm’s Length Principle**

The ALP receives a lot of criticism. One example is that the ALP is subjective in nature and leaves room for interpretation, resulting in discussions between taxpayers and tax administrations; Taxpayers are habitually incentivized to interpret the ALP in their highest favor, and tax authorities do the same on their end. This often leads to technical discussions on whether controlled and uncontrolled transactions are in fact comparable, and whether all terms and conditions must be the same.

Building on this point, lobby groups argue that the ALP facilitates tax avoidance by MNEs by shifting profits from high-tax jurisdictions to low-tax jurisdictions. Oxfam Novib\(^{11}\) sums it up:

*Transfer pricing is an important method used by MNCs to shift profits. The ‘transfer price’ is the price of something traded between two subsidiaries of the same company. This price should be set as though the transaction were being conducted with a third party, using the ‘arm’s length principle’. There are two reasons why this allows profit shifting. First of all, MNCs can design the formal corporate structure and the conditions under which the intra-group transactions are made. The structure and conditions define where the profits are generated. For example, the contracts for intra-group transactions could be defined in the head office, which makes it difficult to establish arm’s length prices. The second reason is the lack of suitable benchmarks. Without suitable benchmarks, MNCs can manipulate their transfer prices to shift profits into tax havens. For example, one part of a MNC can sell a product from a low-tax jurisdiction to another part of the MNC based in a high-tax jurisdiction at an inflated cost, so that*

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they increase sales in the former, and increase costs in the latter. Since a lot of intra-
group trade occurs within MNCs, it is vital that these transactions are fairly priced and
not manipulated to reduce tax liabilities for the group as a whole.

Despite the criticism, the international tax community has not been able to come up with
a workable alternative for the ALP. It is unlikely that an alternative will be available anytime
soon, and thus, the ALP remains the guiding principle for transfer pricing.
Chapter 2 – Why Is Transfer Pricing Important?

We now understand what transfer pricing is. But what does it all mean? In this chapter, we discuss why transfer pricing is important and how it became such a “hot item” for both the media and tax authorities alike.

First, we discuss the share of controlled transactions in world-trade. We then clarify the possible consequences of transfer pricing practices on governments’ tax incomes. Next, we look at the public outcry these practices have created, and their eventual regulation. Finally, we look at the consequences of not following transfer pricing rules.

2.1 – Transfer Pricing Applies to Major Share of International Trade

A widely quoted figure within the transfer pricing world is that around 60% of all international trade happens within, rather than between, MNEs – meaning: across national borders but within the same MNE. We have tried to verify the origins of this percentage. It turns out that it is based on a study looking at trade between the United States and Canada in 1993. This number can therefore not be considered “at arm’s length.”

Unfortunately, there is no real registration between of global trade between associated enterprises. The most reliable figures are obtained through surveys of MNEs, and customs data from the United States. Looking at customs data, trade between associated enterprises in the US in 2010 covered 29% of exports, and 48% of imports. The study also concluded that the number of exports to associated enterprises since 1992 has fallen, whilst imports have roughly remained the same.

Ultimately, a significant part of international trade happens between associated enterprises, resulting in a large number of controlled transactions for which transfer pricing rules apply!

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14 Kim J. Ruhl, “An Overview of U.S. Intrafirm-trade Data Sources,” (New York University, Stern School of Business, May 2013), accessed Oct 8 2018, https://static1.squarespace.com/static/562636cfe4b043d43a7492bf/t/56746f8ca2bab07a743cd858/1450471308822/bea_census_latest.pdf: there is a difference in data, because the two data sources used result in slightly different results. See graph on page 6. The lower numbers being based on surveys (Census), and the larger number based on customs data (BEA). In the study, limitations of both methods are described.
2.2 – Profit Shifting Affects Tax Income

There are huge differences in corporate tax rates (and tax bases) between countries. In countries such as India and Mexico, MNEs can end up paying around 30% corporate tax on their profits. On the other hand, in countries such as the British Virgin Islands and the United Arab Emirates, there is no corporate tax at all\(^\text{15}\) For MNEs, this can be an incentive to shift profits from high-tax, to low-tax countries.

The main goal for transfer pricing rules is to prevent profit-shifting and ensure that profits are allocated in the correct way: where economic activities take place and value is being created.

The next example demonstrates how transfer pricing could be used to shift profits:

**Example 14 – Profit Shifting**

Peter Piano Malaysia (PP MAL) manufactures pianos in Malaysia and Peter Piano Hong Kong (PP HK) sells them from Hong Kong. Both enterprises are 100% owned by Peter Piano China (PP CHI). Since PP CHI directly participates in the capital of both enterprises, they are all associated enterprises.

When selling pianos on the market, PP CHI has no control over the price at which they are sold. Supply and demand set market prices. Currently, the market price for one piano is USD 5,000. Remember, PP CHI has control over any transactions happening between PP MAL and PP HK, and can thus set the transfer price for the internal sale of pianos (the controlled transaction).

The above can be summarized as follows:

---

The price at which one piano is sold by PP MAL to PP HK affects each party's individual financial results (remember: this is the controlled transaction). If PP MAL charges a high price, it makes more profit. If PP MAL charges a low price, PP HK makes more profit.

From an accounting/commercial perspective, the internal price doesn’t matter much. The financial results of PP MAL and PP HK are consolidated at the level of PP CHI, and in that sense it is irrelevant which of the two enterprises reports the highest profit. However, looking from a taxation perspective, it does matter.

PP MAL is taxed in Malaysia and PP HK is taxed in Hong Kong. The corporate tax rate in Hong Kong is 16.5%. In Malaysia, it is 25%. Logically, PP CHI wants to see as much profit after tax as possible. PP CHI can use its influence as a shareholder to set the prices in such a way that the profits are highest where taxes are lowest.

Let’s Now Demonstrate this with Numbers:

Let’s assume that the direct and indirect costs of manufacturing one piano are USD 1,000, and that the average independent piano manufacturer comparable to PP MAL realizes a pre-tax profit of USD 3,000 when selling one piano to a distributor. We already know the market price for one piano: USD 5,000.

We will now show two scenarios. Scenario 1 demonstrates the profits margin should PP MAL charge PP HK the market price for the sale of one piano (USD 4,000 as this results in a profit of USD 3,000). Scenario 2 demonstrates the profits margin should PP MAL charge a non-market price of USD 2,000.

**Scenario 1: Sale of one piano @ market price of USD 4,000**

<table>
<thead>
<tr>
<th></th>
<th>PP MAL (Manufacturer)</th>
<th>PP HK (Distributor)</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>4,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Direct / indirect costs</td>
<td>1,000</td>
<td>4,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>3,000</td>
<td>1,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Tax @ regular rate</td>
<td>750</td>
<td>165</td>
<td>915</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>2,250</td>
<td>835</td>
<td>3,085</td>
</tr>
</tbody>
</table>

In a consolidation, internal dealings are eliminated. In this simplified example that means that the revenues of PP MAL and the direct/indirect costs of PP HK are reduced with 4,000.
Scenario 2: Sale of one piano @ non-market price of USD 2,000

<table>
<thead>
<tr>
<th></th>
<th>PP MAL (Manufacturer)</th>
<th>PP HK (Distributor)</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>2,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Direct / indirect costs</td>
<td>1,000</td>
<td>2,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>1,000</td>
<td>3,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Tax @ regular rate</td>
<td>250</td>
<td>495</td>
<td>745</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>750</td>
<td>2,505</td>
<td>3,255</td>
</tr>
</tbody>
</table>

In scenario 1, the larger portion of profit is reported by PP MAL and taxed at a rate of 25%. In scenario 2, the larger portion of profit is reported by PP HK and taxed at 16.5%. Scenario 2 results in a lower tax burden and an additional profit after tax of USD 170 per piano sold (3,255 – 3,085).

From a financial point of view, Z obviously prefers scenario 2!

2.3 – Politicians, Lobby Groups & the Media

For the past six years or so politicians, lobby groups, and the media have been focusing more on the taxation of MNEs. A famous example is the low effective tax rate of Starbucks in the United Kingdom, for which transfer pricing practices were deemed as the root cause. Politicians and media called it a sham, which led to customers protesting in front of Starbucks shops and even to Starbucks making a voluntary “tax” payment to the United Kingdom tax authorities (HRMC).17

Meanwhile, the European Commission has started something of a crusade against the transfer pricing practices of MNEs. Even certain tax arrangements agreed upfront with local tax authorities in so-called “tax rulings” were labeled as “State-Aid.” In some cases, the European Commission ordered significant tax payments.18 Amazon, Apple, Fiat and Ikea are just a few of the MNEs that have faced such scrutiny by the European Commission.

Politicians and the media feel that MNEs do not pay their “fair share” of taxes, and that governments are losing out on large amounts of tax revenues. Unfortunately, it is difficult to guess how much tax revenue is lost by governments due to transfer (mis)pricing. After all, without global numbers on inter-company trade, it’s hard to come to real conclusions.

In addition, it has to be brought to light that lobby groups, politicians and the media do not always tell the whole story when discussing transfer pricing, and sometimes easily jump to conclusions. Let’s take an example shown on the Tax Justice Network’s website:

**How does World Inc. shift its profits into a tax haven?**

*For example, World Inc. grows a crop in Africa, then harvests and processes it and transports and sells the finished product in the United States. It has three subsidiaries: Africa Inc. (in Africa), Haven Inc. (in a zero–tax haven) and USA Inc. (in the U.S.).*

*Africa Inc. sells the produce to Haven Inc. at an artificially low price. So Africa Inc. has artificially low profits – and therefore an artificially low tax bill in Africa. Then Haven Inc. sells the product to USA Inc. at a very high price – almost as high as the final retail price at which USA Inc. sells the processed product. So USA Inc. also has artificially low profits, and an artificially low tax bill in the U.S. But Haven Inc. is different: it has bought cheaply and sold at a very high price, creating very high artificial profits. Yet it is located in a tax haven – so it pays no taxes on those profits. Voila! A tax bill disappears.*

Crucial information is missing. For example, there is no information on the functionality of each of the subsidiaries, such as which entity owns and manages the brand needed to sell the end product? Who provides the scientific knowledge needed to grow the crop? And where are the key employees located? These days, many MNE’s actually have employees located in countries designated as “tax havens.”

Without this and other crucial information, it is hard to say anything sensible about the allocation of profits among the associated enterprises. Politicians, lobby groups and the media often ignore this.

Having said all this, there can be little debate that MNEs have used, and in some cases continue to use, transfer pricing practices to lower their tax bill. In the next section, we summarize what has been done to regulate this practice.

### 2.4 – Regulation and Compliance

Transfer pricing regulation is not new. In fact, Western governments were already tackling the issue in the 90’s. Even though the OECD and other organizations have been steadily working on international standards, the Base Erosion and Profit Shifting (BEPS) initiative however is what really set off a chain reaction.

The concept of BEPS was raised at a G20 meeting in June 2012. Shortly after, the OECD published its first report on BEPS in February 2013, in which transfer pricing regulation was named as a crucial tool in the fight against BEPS. This was followed by an

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20 See for example section § 482 - Allocation of income and deductions among taxpayers of the US Tax Code first published in 1994, which already mentions the ALP, method selection and comparables.

“Action Plan on BEPS,” published in July 2013, including a number of action points regarding transfer pricing.\textsuperscript{22}

Besides the G20 and the OECD, other international political organizations such as the United Nations\textsuperscript{23} and the European Union\textsuperscript{24} have added their own publications on BEPS, expressing commitment to tackle the issue. All of this political force created sufficient momentum for the implementation of the OECD’s BEPS initiative by governments worldwide. This resulted in increased regulation of transfer pricing on a global scale.

2.4.1 – Hard vs Soft Laws

The OECD remains the source of most transfer pricing rules. This organization, like most international organizations, generally only creates rules that are qualified as “soft laws.” Soft laws are rules that do not have any legally binding force, or whose binding force is weaker than the binding force of traditional laws. The latter are often referred to as “hard laws.” In order for the OECD’s transfer pricing rules to have effect, OECD Member States must implement them in domestic laws or tax treaties to become “hard laws.”

In reality, most OECD Member States (and an increasing number of non-OECD Member States) have implemented the OECD’s transfer pricing rules in domestic laws and tax treaties. The benefit of this is that the framework of transfer pricing rules are equally applicable in many countries around the world. However, there are differences in the implementation and enforcement of these rules. Consequently, it is essential to be compliant with domestic transfer pricing rules.

2.4.2 – Penalties\textsuperscript{25}

Transfer pricing penalties most often aim at ensuring compliance, whether with procedures, such as filing returns, or a substantive determination of tax liability.

Penalties can involve either civil or criminal sanctions, but criminal penalties are virtually always reserved for cases of very significant fraud. Administrative penalties are more common, and they typically involve a monetary sanction.


For example the following action points: “ACTIONS 8, 9, 10 Assure that transfer pricing outcomes are in line with value creation” and “ACTION 13 Re-examine transfer pricing documentation.”


\textsuperscript{25} OECD, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,” Chapter 4B.3
Tax systems, and therefore penalty practices and policies, differ widely amongst countries. But it is common though for a tax understatement to be sanctioned with a fine, calculated as a percentage ranging from 10% to 300% of the understatement. Given the fact that transfer pricing cases often cover multiple tax years, this can get costly.

For balance, the OECD advises against imposing sizable penalties on taxpayers who have made a reasonable effort to set the prices for their controlled transactions in accordance to the arm’s length principle. In a sense, observing the ALP and documentation requirements should eliminate most risk for penalties – as opposed to not substantiating prices, or worse, evading taxes.

**Example 15 – Ignoring transfer prices can be costly!**

Bill Bananas is an enterprise that produces bananas. It wishes to expand its product portfolio with apples. In 2017, Bill Bananas approaches Andy Apples, a producer of apples, to understand if they are interested in an acquisition. Andy Apples is indeed interested. Andy Apples undergoes financial due diligence by Bill Bananas. It turns out that Andy Apples has been operating since 2007 through a Hong Kong legal entity (Andy Hong Kong), that owns all the shares in an enterprise in Australia (Andy Australia). Andy Hong Kong buys the apples from Andy Australia, and sells them to clients in Hong Kong. Andy Australia does not sell apples to external clients. The financial administration of Andy Australia and Andy Hong Kong doesn’t reveal much of the controlled transactions between them. It does reveal however that Andy Australia has not been profitable since 2007. The financial advisor for the due diligence, doing his “check-the-box” exercise, asks if there is a transfer pricing policy in place and if the transactions are substantiated with documentation. The answer is: no.

After conclusion of the due diligence, Bill Bananas decides to purchase Andy Apples for USD 1,000,000. This price equals ten times the consolidated annual EBIT of Andy Hong Kong and Andy Australia of USD 100,000. No guarantees or indemnities are agreed upon for transfer pricing on controlled transactions between Andy Hong Kong and Andy Australia before the change of ownership. Bill Bananas is happy with this price and the new product line.

Shortly after closing the deal, the Australian tax authorities (ATO) knock on the door. They request to review Andy Australia’s policy and documentation. Andy Australia cannot provide this. As mentioned earlier, transfer pricing has never been considered. The ATO take the position that the transactions were not concluded at arm’s length terms and conditions. The ATO then rules that Andy Australia should have reported a cost-plus remuneration on all years since incorporation. Ten years of losses are converted to ten years of profits. In addition, penalties and interest for late tax payments are due. The total tax bill presented is USD 500,000. Bill Bananas, the new owner, is no longer happy.

With basic knowledge on transfer pricing, this situation could have been avoided!
Chapter 3 – The Nine-Step Transfer Pricing Analysis

Transfer Price Analysis (TPA) is an important aspect of transfer pricing. The analysis produces the information necessary to determine the correct transfer price for a controlled transaction.

The TPA can make or break the defense of transfer pricing policies against tax authorities. If you do your homework, the risk of challenges from the authorities can be reduced significantly. This in mind, investment in a solid TPA eventually pays for itself.

In this chapter, we introduce a Nine-Step TPA approach. It is roughly based on the OECD Guidelines, which set forth nine steps to perform a “comparability analysis.” This process is not linear however, and certain steps may need to be done twice.

The search for “comparables” is essential to the TPA. A comparable is an arm’s length transaction used to compare your controlled transaction with. It cannot be any transaction. According to the OECD:

* Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology (e.g. price or margin), or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.*

We discuss comparability further in Chapter 3.3.

3.1 – Step 1 – Determine the years to be covered

The first step is to decide which financial years are to be covered in the TPA. This depends on domestic legislation: some countries allow a TPA that spans multiple years; others allow an analysis for one year. In practice, most TPA’s cover three years.

3.2 – Step 2 – Analyze the taxpayer’s circumstances.

The second step is a broad-based analysis of the taxpayer’s facts and circumstances. It can be defined as an analysis of the industry, competition, economic and regulatory factors, and other elements affecting the taxpayer and their environment. This step doesn’t yet look at the specific transactions in question.

Instead, it helps the reader understand the conditions of the controlled transaction, as well as those of the uncontrolled transactions to be compared and the economic circumstances of the transaction.

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26 OECD, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,” Par. 3.4
In transfer pricing documentation, the information gathered under Step 2 is roughly included along these lines:

<table>
<thead>
<tr>
<th>Business Overview</th>
<th>Industry Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Strategic focus</td>
<td>• Overview of main industry</td>
</tr>
<tr>
<td>• Business segments</td>
<td>• Business segments</td>
</tr>
<tr>
<td>• International presence</td>
<td>• Industry forecast</td>
</tr>
<tr>
<td>• Competition</td>
<td>• Industry success factors and risks</td>
</tr>
<tr>
<td>• Acquisitions and divestitures</td>
<td>• Industry trends and forecast</td>
</tr>
<tr>
<td>• Locations</td>
<td></td>
</tr>
</tbody>
</table>

### 3.3 – Step 3 – Define the Controlled Transaction; Select the “Tested Party”

The third step is understanding the controlled transaction(s) under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method), and to identify the significant comparability factors that should be taken into account.  

#### 3.3.1 – Defining the Controlled Transaction

When defining the controlled transaction, try to be as specific as possible. It is better to be overly specific than too broad.

**Example 16 – Defining the Controlled Transaction I**

Singapore Magic Mobile owns all the shares of Philippines Magic Mobile. Philippines Magic Mobile manufactures high-end smartphones. Singapore Magic Mobile distributes these phones. The manufacturing business and distribution activities happen in different jurisdictions. Singapore Magic Mobile wants to put a transfer pricing policy in place for the manufacturing activities. It could then consider “manufacturing of high-end smartphones” as controlled transaction. This sufficiently narrows the scope of comparables. For example, “manufacturing of smartphones” or “manufacturing of phones” could yield an overly broad data sample.

**Example 17 – Defining the Controlled Transaction II**

Andy Apples sells Australian red apples exclusively to associated enterprises. At some point, a transfer pricing policy is put in place for the sales. As controlled transaction should then preferably be considered: “sales of red apples” or alternatively “sales of apples” and not “sales of fruit.” But why? It’s because the sale of an apple in general is substantially different than, for example, the sale of an orange. And we do not want to compare apples to oranges!

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28 OECD, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,” Par. 3.4
3.3.2 – Functional Analysis

The functional analysis looks at what each associated enterprise does in relation to a controlled transaction. It considers the functions performed, assets used, and risks assumed by each associated enterprise involved in the controlled transaction. It thus helps attain an understanding of value creation within the supply chain in general, as well as the controlled transaction in particular. As a result, it provides an understanding of the associated enterprises’ relative contributions towards the controlled transaction, and their roles in overall value creation.

A functional analysis involves data research and interviews with employees of the associated enterprises. Eventually, the functional analysis should be clearly spelled out in transfer pricing documentation, with a clear description of the functions performed, risks assumed, and assets used with respect to the controlled transaction.

3.3.3 – Selecting the Tested Party

For the Cost Plus Method, Resale Price Method and Transactional Net Margin Method (see Chapter 4), it is necessary to select one of the associated enterprises involved in the controlled transaction to test the profitability (mark-up on costs, gross margin, or net profit margins) and compare the profitability of the tested party’s transactions with uncontrolled comparable transactions. This party is called the “Tested Party.”

The choice of the tested party should be consistent with the functional analysis of the transaction. As a general rule, the tested party is the party to which a transfer pricing method can be applied in the most reliable manner, and for which the most reliable comparables can be found. Often, it’s the one with the least complex functional analysis.

**Example 18 – Tested Party**

The Cycling Factory manufactures two types of bicycles:

1) a regular bicycle *(Product 1)*
2) an electronic bicycle *(Product 2)*.

It sells these to **Cycling Distribution**, an associated enterprise in another country.

The Cycling Factory manufactures Product 1 using valuable and unique intangibles belonging to Cycling Distribution. For the manufacturing process, it follows technical specifications set by Cycling Distribution. For the sale of Product 1, The Cycling Factory only performs simple functions and does not make any valuable or unique contribution in relation to the transaction. The tested party for the sale of Product 1 would most often be The Cycling Factory. For the TPA, enterprises with a comparable functionality to The Cycling Factory must be looked to.

The Cycling Factory also manufactures Product 2, for which it owns and uses valuable unique intangibles such as patents and trademarks. Cycling Distribution acts as the distributor. In this transaction, Cycling Distribution only performs simple functions and does not make any valuable, unique contribution in relation to the
transaction. The tested party for the Product 2 transaction would most often be Cycling Distribution. For the TPA, enterprises with a comparable functionality to Cycling Distribution must be looked at.29

3.4 – Step 4 – Review Existing Internal Comparables (if any)

Before looking at external comparables, it’s good practice to check for internal comparables first. An internal comparable is a transaction similar to the controlled transaction.

Internal comparables can have a more direct and closer relationship to the transaction under review than external comparables. The financial analysis is likely easier and more reliable too, as it will presumably be based upon identical accounting standards and practices. In addition, access to information on internal comparables is usually both more complete and less costly. It is thus sensible to check for internal comparables.

If not present at the taxpayer, perhaps other associated enterprises can offer an internal comparable transaction. Those operating in a different region are a good example of this.

Example 19 – Comparable transactions within MNEs

Andy Apples Australia only sells Australian red apples to associated enterprises. Hence, there is no CUP available. However, Andy Apples New Zealand, which is part of the same MNE but carries out activities in New Zealand, does sell the same Australian Apples to associated enterprises. In fact, Andy Apples New Zealand has already performed a transfer pricing analysis for these activities. In this case, there can be good arguments for Andy Apples Australia to rely on the transfer pricing applied by Andy Apples New Zealand.

Example 20 – Pricing Policies

MNEs with manufacturing or sales activities usually work with pricing policies. Prices depend on factors such as the size of the order, whether the client is a first time client or a recurring client etc. If applied equally to controlled transactions and uncontrolled transactions, such a pricing policy could serve to defend transfer pricing towards tax administrations.

3.5 – Step 5 – Finding “Prices” – Sources for External Comparables

If internal sources do not provide sufficient information, it is necessary to look at external sources. There are various external sources available, and the most important ones are paid databases.

3.5.1 – Third-Party Databases

Database providers collect data on terms and conditions of numerous (external) transactions, and combine that into digestible reports.

29 OECD, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,” These examples are based on examples provided in par. 3.19.
There are databases specifically focused on Intellectual Property transactions which produce market terms and conditions for licensing transactions between independent enterprises. There are also databases specifically focused on loans, which allow you to peruse terms and conditions of loan transactions between independent enterprises. Other databases cover a broad scope of businesses, of which databases like Bureau van Dijk and ORIANA are the most widely used. In short, an incredible amount of data is out there!

Using external databases to collect information on terms and conditions of controlled transactions is the standard in transfer pricing practice – both for tax authorities and MNEs. It provides a concrete foundation on which to base your transfer pricing policy.

The main disadvantage of using external databases is that access is usually based on annual subscription. For MNEs, this can become a costly affair and it can be more beneficial to work with an external transfer pricing expert who has such a subscription.

3.5.2 – Alternative External Sources

Third-party databases are not your only option. There are other sources available that provide information for market prices and can be used to substantiate the pricing of controlled transactions.

One example is a third-party valuation report for real- or intellectual property. Other options are publicly available advertisements, industry-specific publications or distributor price lists. Published annual reports could be another great source for data, as well as competitor quotations.

3.5.3 – What Kind of Data Should You Collect?

Once the comparable uncontrolled transactions have been identified, the next thing is to obtain the terms and conditions that apply to these transactions. We specifically mention terms and conditions, and not just prices. After all, transactions differ in multiple ways. For example, two loans can have the same interest rate, but different repayment conditions. Equally, two similar shipments of banana could have different shipping conditions.

In short, terms and conditions depend on the type of transaction.

Example 21 – Terms and Conditions I

Bill Bananas sells Costa Rican bananas to associated enterprises. Here, as controlled transaction should preferably be considered: “sales of Costa Rican bananas,” or alternatively: “sales of bananas.” Database research brings up ten potentially comparable transactions. It would be good to evaluate the following terms and conditions of these transactions:

• Sales price
• Payment conditions
• Shipping conditions
• Quality assurance arrangements
**Example 22 – Terms and Conditions II**

Vietnam Finance is a part of Asia Finance and has provided a one-year loan of USD 1m to associated enterprise, Thailand Finance. The controlled transaction is thus: “provision of a USD 1m loan to a Thai associated enterprise.” The comparable transaction likewise is: “provision of a USD 1m loan to a Thai enterprise.” Database research shows ten potentially comparable transactions. It would be good to evaluate the following terms and conditions of these loans:

- Interest rate
- Terms of the loan
- Payment conditions
- Events of default
- Securities (e.g. pledge on assets)
- Possibility for extension

You will find that with most transactions, terms and conditions tend to differ. In general, only significant differences will make a transaction incomparable. If there are small differences, but the transaction is essentially the same as the controlled transaction, it can still qualify as comparable.

For example, you have found a loan transaction identical to the controlled transaction, except that the events of default (the circumstances under which the loan becomes instantly due and payable) slightly differ. In itself this should not be a reason to disqualify the loan transaction as comparable.

### 3.6 – Step 6 – Select the Most Appropriate Transfer Pricing Method

The next step is to select the most appropriate transfer pricing method. Thinking about the transfer pricing method at this stage can help to target the search for comparables. However, it might turn out that for the chosen method, there are insufficient comparables. In this case, this step needs to be revisited.

Transfer pricing methods can be divided into two groups: “traditional transaction methods” and “transactional profit methods.”

<table>
<thead>
<tr>
<th>Traditional Transaction Methods</th>
<th>Transactional Profit Methods</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUP Method</td>
<td>Transactional Net Margin Method (TNMM)</td>
</tr>
<tr>
<td>Resale Price Method</td>
<td>Transactional Profit Split Method</td>
</tr>
<tr>
<td>Cost Plus Method</td>
<td></td>
</tr>
</tbody>
</table>

We discuss the details of each of these methods in Chapter 4.
3.7 – Step 7 – Identify Potential Comparables

Based on the information gathered from internal and external sources, potentially comparable uncontrolled transactions can be identified. To have a good benchmark on the terms and conditions for the controlled transaction, it is necessary to have information for between five and ten comparables.

You may be unable to find sufficient information on comparable uncontrolled transactions. There can be valid reasons for that, such as the type of transaction being rare. For example, selling apples is more common than selling Van Gogh paintings. There may also be no reliable data available for the comparables.

The common way to address the issue of insufficient information on comparables is to allow a lower level of comparability, meaning that you allow the comparables to broadly resemble the controlled transaction(s). This is best demonstrated with an example:

Example 23 – Insufficient information

Danny Distribution distributes vacuum cleaners to associated enterprises. Danny Distribution wants to verify whether the terms and conditions of its distribution activities are at arm's length. As comparable transactions are considered: “distribution of vacuum cleaners.” The sources used however only show data on two potential comparables, which is clearly not enough to make a proper benchmark. Thus, Danny Distribution instead uses: “distribution of household appliances,” to find more comparables.

3.8 – Step 8 – Make Comparability Adjustments (if needed)

Remember, in a TPA, the terms and conditions of a controlled transaction are compared to the conditions of comparable uncontrolled transactions. This implies that there should not be any difference between the transactions which materially affect the conditions examined under the transfer pricing methodology (e.g. price or margin). However, even if such differences exist, comparability can still be achieved by “comparability adjustments.”

A “comparability adjustment” is an adjustment made to the conditions of uncontrolled transactions to eliminate the effects of material differences that exist between them and the controlled transaction in examination. The below example of a comparability adjustment comes from the OECD:

For instance, assume that a taxpayer sells the same products to an associated enterprise and to an independent enterprise. Assume that the two sales transactions are comparable, except that, in the controlled transaction (sale by the taxpayer to its associated enterprise), the currency risk is borne by the taxpayer while in the uncontrolled transaction (sale by the taxpayer to an independent enterprise), the currency risk is borne by the customer. Assume that the different allocations of this risk in the controlled and uncontrolled transactions materially affect the comparison, because the currency risk is significant. In such a case, it may nevertheless be possible to use the uncontrolled transaction as a comparable to the controlled
transaction, subject to an adjustment being made to eliminate the effects on the comparison of the different allocations of currency risk.\(^{30}\)

### 3.9 – Step 9 – Analyze and Use the Data; Determine the Transfer Price

The final step is to interpret and use the data gathered during the research. With it, the transfer pricing for the controlled transaction(s) can be determined. It makes sense to prepare a write-up of the steps taken in the analysis, and to create a back-up of the data gathered. This makes the preparation of the transfer pricing documentation much easier. In Chapter 5, we present a simple method for creating such documentation. But before we continue, we must address one more crucial point of the TPA: the arm’s length price range.

#### 3.9.1 – The Arm’s Length Range

The outcome of the TPA will be a range of values (prices) for comparable uncontrolled transactions. The next step is to analyze these values by using the Quartile Function.\(^{31}\) In transfer pricing, we are mainly interested in the following three values from a set of data:

1. **The first quartile (or lower quartile):** the lowest 25% of the values.
2. **The median (or second quartile):** divides the range in the middle, and has 50% of the data below it.
3. **The third quartile (or upper quartile):** has 75% of the data below it, and the top 25% of the data above it.

The relevance of these values for transfer pricing can be summarized in two statements:

1) An arm’s length value falls in between the lower quartile and upper quartile, i.e. within the interquartile range. Values below the first quartile and above the third quartile disqualify as arm’s length value.

2) The median is usually the default arm’s length value and as such, advisable to use as transfer price.

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\(^{30}\) OECD, “Comparability Adjustments,” (Centre for tax policy and administration, July 2010), http://www.oecd.org/tax/transfer-pricing/45765353.pdf; page 2

\(^{31}\) An example on how to calculate quartiles and the median in excel, can be found on this page on the website of Microsoft Office.
**Example 24 - Selfie Phones**

Philippines Mobile sells high-end smartphones in the Philippines. Its shares are fully owned by Singapore Mobile. The smartphone they sell is the “Matrixphone,” which is the absolute number one for Filipinos, due to its camera that takes superb selfies. Singapore Mobile has given Philippines Mobile an exclusive license to sell various versions of the “Matrixphone.” In return, Philippines Mobile pays Singapore Mobile a royalty fee based on its annual net revenues. Singapore Mobile wishes to analyze the arm’s length price for this license, and has identified fifteen comparable uncontrolled transactions in the category “provision of license for selling high-end smartphones with according values” (royalty fees). The results of the research are:

<table>
<thead>
<tr>
<th>Comparable Licensing Transactions</th>
<th>Royalty Fee (on net revenues)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>8.00%</td>
</tr>
<tr>
<td>2</td>
<td>1.00%</td>
</tr>
<tr>
<td>3</td>
<td>0.50%</td>
</tr>
<tr>
<td>4</td>
<td>3.00%</td>
</tr>
<tr>
<td>5</td>
<td>6.00%</td>
</tr>
<tr>
<td>6</td>
<td>6.00%</td>
</tr>
<tr>
<td>7</td>
<td>4.60%</td>
</tr>
<tr>
<td>8</td>
<td>5.00%</td>
</tr>
<tr>
<td>9</td>
<td>11.00%</td>
</tr>
<tr>
<td>10</td>
<td>4.00%</td>
</tr>
<tr>
<td>11</td>
<td>7.50%</td>
</tr>
<tr>
<td>12</td>
<td>3.10%</td>
</tr>
<tr>
<td>13</td>
<td>5.00%</td>
</tr>
<tr>
<td>14</td>
<td>2.40%</td>
</tr>
<tr>
<td>15</td>
<td>10.00%</td>
</tr>
</tbody>
</table>

Based on this range of values, the following conclusions can be drawn:

- A royalty fee below 3.05% or above 6.75% is not arm’s length as such a value doesn’t fall within the interquartile range.
- A royalty fee between 3.05% and 6.75% can be considered arm’s length, as such a value falls within the interquartile range.
- The median value is 5%, and this is the default arm’s length royalty fee.

Singapore Mobile doesn’t wish to set the royalty fee at the median value of 5%. Instead, it sets it at 6.5%, to increase revenues in Singapore. This is not standard practice, and as a result increases the risk of challenges from the Philippine tax authorities (BIR). However, Singapore Mobile can do so as the value still falls within the arm’s length range.\(^32\)

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\(^32\) For completeness’ sake, we note that a factor to consider is that many countries levy withholding tax on royalty fee payments. In this case the royalty fees to be paid by Philippines Mobile will be subject to withholding tax in the Philippines. If this withholding tax cannot be credited in Singapore, this taxation will be a real cost.
Chapter 4 – Transfer Pricing Methods

The good thing about transfer pricing is that its principles and practices are similar around the world. The OECD Guidelines provide five common methods, accepted by almost all tax authorities.\textsuperscript{33} This chapter describes how every method is applied, and presents examples of their use. The end of the chapter includes a step-by-step process that you can use for selecting the correct method in any particular case.

4.1 – Traditional Transaction Methods vs. Transactional Profit Methods

Transfer pricing methods can be divided into: “traditional transaction methods” and “transactional profit methods.”

Traditional transaction methods measure terms and conditions of actual transactions between independent enterprises and compare these with those of controlled transactions. This comparison can be made based on direct measures, such as the price of a transaction, but also based on indirect measures, such as gross margins realized on particular transactions.

Transactional profit methods don’t measure the terms and conditions of actual transactions. In fact, these methods measure the net operating profits realized from controlled transactions, and compares them to profit levels realized by independent enterprises engaged in comparable transactions. Transactional profit methods are less precise than traditional transaction methods, but much more often applied. This is because the application of traditional transaction methods, which is preferred, requires detailed information. In practice, this information can be hard to find.

To summarize: traditional transaction methods compare terms and conditions of actual transactions, while traditional profits methods rely on profit levels.

As mentioned, the OECD Guidelines discuss five transfer pricing methods that may be used to examine the arm’s length nature of controlled transactions. Three of these methods are traditional transaction methods while the remaining two are transactional profit methods. As is shown in the following graph:

<table>
<thead>
<tr>
<th>Traditional Transaction Methods</th>
<th>Transactional Profit Methods</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUP Method</td>
<td>Transactional Net Margin Method (TNMM)</td>
</tr>
<tr>
<td>Resale Price Method</td>
<td>Transactional Profit Split Method</td>
</tr>
<tr>
<td>Cost Plus Method</td>
<td></td>
</tr>
</tbody>
</table>

\textsuperscript{33} OECD, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations” Chapter II – Transfer Pricing Methods
4.2 – Method I – The CUP Method

The CUP Method is a traditional transaction method and compares the terms and conditions (including the price) of controlled transactions with the those of comparable uncontrolled transactions between independent enterprises. The following types of comparable uncontrolled transactions can be used for the purposes of the CUP Method:

1. A transaction between the taxpayer and an independent enterprise
2. A transaction between two independent enterprises

In case the transaction under 1) is comparable to the controlled transaction, its terms and conditions may be considered an “Internal CUP.” In case the transaction under 2) is comparable to the controlled transaction, its terms and conditions may be considered an “External CUP.”

The below chart shows the difference between the two applications of the CUP Method:

Example 25 – Internal and External CUP

The Cleaning Corporation manufactures the “Buster 3.0,” a high-quality vacuum cleaner. It is up to ten times stronger than the models of most competitors. The only competing manufacturer offering a vacuum cleaner of comparable quality is The Dust Company, with its renowned “Dragon Buster.” Both enterprises sell their vacuum cleaners via both associated and third party distributors. They also operate similarly.

The Cleaning Corporation has received an order from an Associated Distributor for the supply of one Buster 3.0. It wonders what transfer price it should apply. To achieve
this, it should find the terms and conditions (here: the price) of a comparable
transaction. Under the CUP method, there are now 2 options:

- **Option 1** - The Cleaning Corporation looks at the price for which it sells one
  “Buster 3.0” to an independent enterprise (Internal CUP).
- **Option 2** - The Cleaning Corporation looks at the price for which The Dust
  Company sells one “Dragon Buster” to an independent distributor (External
  CUP).

Obviously, option 1 is the easiest here and would be acceptable. But option 2 would
also be acceptable while securing a better defense towards tax authorities, since The
Cleaning Corporation “is doing what an independent enterprise does.”

The below example summarizes the use of the CUP Method in this case:

---

**4.2.1 – Use of the CUP Method In Practice**

The CUP method is the most reliable way to apply the ALP to a controlled transaction. In
case there would be a clear isolated CUP, it would be difficult, if not impossible, for a tax
authority to challenge the use of the CUP method.

The disadvantage of the CUP method is that it is difficult to (a), find transactions
sufficiently comparable to a controlled transaction, and (b), find quality data on such
transactions.

In practice, the CUP method is often used for financial transactions such as group loans
and IP transactions. These types of transactions occur often between independent
enterprises and there is plenty of data available on the market. For example, most banks
work with the same formulas to determine borrowers’ credit ratings and according interest rates. This can be applied equally for controlled loan transactions.

4.3 – Method II – The Resale Price Method

The Resale Price Method is a traditional transaction method, and is also known as the “Resale Minus Method.”

As a starting position, it takes the price at which an associated enterprise sells a product to independent enterprises. This price is called a “resale price.” The resale price is then reduced with a gross margin (the “resale price margin”), determined by comparing gross margins in comparable uncontrolled transactions. After this, costs associated with the purchase of the product, such as custom duties, are deducted. What is left can then be regarded as an arm’s length price.  

The figure below models the Resale Price Method:

Example 26 – Resale Price Method

Apple & Pear, based in Hong Kong, brews an exclusive non-alcoholic beverage called “the Mountain.” It sells this beverage to high-end nightclubs around Asia via associated distributors. The market price for one bottle of “the Mountain” is USD 100. Apple & Pear does not sell the beverage to independent distributors. Also, there is no other enterprise in Asia brewing a comparable beverage.

However, there are comparable distributors selling “the Vulcano.” This is a comparable alcoholic beverage brewed by Gin & Juice, an enterprise also based in

---

34 OECD, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,” Para. 2.27
Hong Kong. The market price for one bottle of “the Vulcano” is USD 100. In addition, distributors report USD 5 gross margin per bottle sold with USD 2 on custom duties.

Apple & Pear wants to set the transfer price for the supply of “the Mountain” to the associated distributors. There is no Internal Cup (no transactions with independent enterprises by Apple & Pear) or External Cup (no comparable transactions). As a result, the CUP method can’t be applied here.

In our example, the distributors of “the Vulcano” are comparable to the distributors of “the Mountain.” The result is that the gross margin and custom duties reported by Gin & Juice can be used as input for the Resale Price Method.

This would look as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market price one bottle of The Mountain at distributor</td>
<td>100</td>
</tr>
<tr>
<td>-/- gross margin associated distributo</td>
<td>5</td>
</tr>
<tr>
<td>-/- custom duties associated distributor</td>
<td>2</td>
</tr>
<tr>
<td><strong>Transfer price</strong></td>
<td><strong>93</strong></td>
</tr>
</tbody>
</table>

In this example, when using the Resale Price Method, Apple & Pear should charge a transfer price of USD 93 to its associated distributors.

**4.3.1 – Use of Resale Price Method in Practice**

The advantage of the Resale Price Method is that it assures a high level of accuracy on the transfer pricing of some types of transactions, provided that (a), the comparable uncontrolled transactions are nearly identical to the controlled transaction, and (b), there is quality data available on those transactions. In practice, the latter requirement is hard to meet. As a consequence, the Resale Price Method is not often used.
4.4 – Method III – The Cost Plus Method

The Cost Plus Method is a traditional transfer pricing method. It uses the costs incurred by the supplier of property (or services) in a controlled transaction. An appropriate “Cost Plus Mark-up” is added to this cost, to make an appropriate profit considering the functions performed (taking into account the assets used and risks assumed) and market conditions.

What is arrived at after adding the cost plus mark-up to the above costs may be regarded as an arm’s length price of the original controlled transaction, and is demonstrated in the next figure:

Example 27 – Cost Plus Method

Candy Casing manufactures iPhone cases for associated enterprises. There are many enterprises manufacturing iPhone cases, including independent enterprise Ali Accessories. Both enterprises manufacture similar iPhone cases.

Associated Distributor ask Candy Casing to manufacture 100,000 iPhone cases. Candy Casing wonders which transfer price it should charge. It must thus find the terms and conditions (here: the price) of a comparable transaction.

Under the Cost Plus Method, Candy Casing should first compare its cost base with the cost base of Ali Accessories when manufacturing 100,000 iPhone cases for independent enterprises. Provided that the cost base is comparable, the next step is to identify the mark-up on costs applied by Ali Accessories. That mark-up should be added to the cost by Candy Casing and the result is the arm’s length price.

35 OECD, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,” Para. 2.45
4.4.1 – Use of the Cost Plus Method in Practice

The Cost Plus Method can be helpful to assess the arm’s length remuneration of low-risk, routine-like activities. An example of such activities is contract manufacturing, where there is a manufacturing enterprise which exclusively contracts with one client (principal) and assumes limited risks. Many MNEs in the automotive industry operate under such a model. Another example is the provision of administrative services.

The disadvantage of the Cost Plus Method is that it needs controlled and uncontrolled transactions to be highly comparable. To establish such a level of comparability, detailed information on the transactions should be available. Examples are the types of products manufactured, actual activities, cost structures and the use of intangible assets. In case this information is unavailable, the Cost Plus Method cannot be applied. As a result, in practice, the Cost Plus Method is not often used.
4.5 – Method IV – TNMM

The TNMM (Transactional Net Margin Method), is a transactional profit method. A transactional profit method measures the net operating profits realized from controlled transactions. It then compares this to the profit level realized by independent enterprises engaging in comparable transactions. For the TNMM, the net profit of a controlled transaction at the level of an associated enterprise (tested party) is used for this comparison.

As opposed to other transfer pricing methods, the TNMM requires transactions to be “broadly similar” to qualify as comparable. “Broadly similar” in this context means that the compared transactions don’t have to be identical to the controlled transaction. This largely increases the number of situations where the TNMM can be used.

4.5.1 – TNMMs Key Element: The Profit Level Indicator

The key element of the TNMM is the so-called Profit Level Indicator (PLI). The PLI is a measure of a company’s profitability used to compare comparables with a tested party. It expresses profitability in relation to sales, costs or expenses, or assets. Commonly applied PLIs are the “Net Cost Plus Margin” and the “Net Resale Minus Margin.”

4.5.2 – Net Cost Plus Margin

The Net Cost Plus Margin is the ratio of operating profit to total cost. If written down in a formula, this would look like this:

\[
\text{Net Cost Plus Margin} = \frac{\text{Operating Profit}}{\text{Total Costs}}
\]

As “Operating profit,” usually “Earnings before Interest and Taxes” is used, or simply: “EBIT.” Total cost means the direct and indirect operational costs without extraordinary items.

The Net Cost Plus Margin measures the return on total costs of a company. By using this ratio, the comparison eliminates differences resulting from categorizing costs. Categorizing costs makes it difficult – if not impossible – to make a good comparison, for example when they are categorized as “costs of goods sold” in a controlled transaction, and “operating costs” in an uncontrolled one.

This type of net comparison is not allowed under the Cost Plus Method, which is a traditional transactional method. That method uses information on gross level – and thus requires costs to be properly categorized.

If the TNMM uses the Net Cost Plus Margin as net profit indicator, one often refers to it simply as the Net Cost Plus Method. This method is often used for low-risk routine-like activities such as manufacturing and the provision of administrative support services.
Example 28 – Net Cost Plus Margin

**Step 1:** Saida Strategy renders strategic advisory services to associated enterprises. An associated enterprise requests strategic advisory services equaling around 1,000 hours.

Saida Strategy knows that the total costs associated with 1,000 hours of services is USD 125,000. It wonders how much to charge for its transfer price. To calculate this, it should find the terms and conditions (here: the price) of a comparable transaction.

There are numerous enterprises around offering similar strategic advisory services (remember for the TNMM comparable transactions may be broadly similar). Saida Strategy has identified ten independent enterprises as comparables. It can now look at the net profit of these enterprises to determine the right arm’s length price for its services. But how?

As mentioned, with the Net Cost Plus method, we first should find the average ratio of EBIT to total cost. The average numbers of the ten comparables are as follows:

<table>
<thead>
<tr>
<th>Average Profit &amp; Loss Comparables</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Revenue</td>
<td>500,000.00 USD</td>
</tr>
<tr>
<td>Labor Costs</td>
<td>-225,000.00 USD</td>
</tr>
<tr>
<td>Office Expenses</td>
<td>-100,000.00 USD</td>
</tr>
<tr>
<td>Selling and other operating expenses</td>
<td>-75,000.00 USD</td>
</tr>
<tr>
<td>Total Costs</td>
<td>-400,000.00 USD</td>
</tr>
</tbody>
</table>

**Profit (EBIT)**

\[
\text{Net Cost Plus Margin} = \frac{\text{EBIT}}{\text{Total Costs}} = \frac{100,000.00 USD}{400,000.00 USD} = 0.25
\]

**Step 2:** The second step is to use the Net Cost Plus Margin to calculate the arm’s length transfer price. To calculate the transfer price, one simply should add the Net Cost Plus Margin to the existing total cost.

The total costs associated with 1,000 hours of services are USD 125,000. The Net Cost Plus Margin is 0.25 (USD 31,250). If we add the amount of the Net Cost Plus Margin to the total cost, we end up with a total transfer price of USD 156,250. By dividing this total transfer price by 1,000 hours worked, we end up with an arm’s length hourly rate of USD 156.25!
4.5.3 – Net Resale Minus Margin

The Net Resale Minus Margin is the ratio of EBIT to turnover. It measures an enterprise’s return on sales. Using this net ratio, the comparison eliminates differences resulting from categorizing sales under sales revenues or other revenues. This is not allowed under the traditional transactions method Resale Price Method, as that method uses information on gross sales level – and thus demands a detailed specification.

If the TNMM uses the Net Resale Minus Margin as a net profit indicator, it is often referred to as the Net Resale Minus Method. This method is often used for sales and distribution activities.

Let’s see how this looks:

**Example 29 – Net Resale Margin**

**Step 1:** Desi Distribution renders distribution services. An associated enterprise requests these services. It should thus find the terms and conditions (here: the price) of a comparable transaction.

There are many enterprises around that provide comparable services. Desi Distribution has identified 10 independent enterprises as comparables. It can now look at these enterprises to find the right transfer pricing.

With the Net Resale Minus Method, we should first find the ratio of EBIT to turnover. Let’s say that the average numbers of the ten comparables are as follows:

<table>
<thead>
<tr>
<th>Average Profit &amp; Loss Comparables</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Revenue</td>
</tr>
<tr>
<td>Costs of goods sold</td>
</tr>
<tr>
<td>Selling and other operating expenses</td>
</tr>
<tr>
<td>Total Costs</td>
</tr>
<tr>
<td>Profit (EBIT)</td>
</tr>
</tbody>
</table>

The Net Resale Minus Margin = EBIT(75,000) / Turnover (500,000) = 0.15

**Step 2:** The second step is to calculate the arm’s length transfer price. For this, you simply charge a price at which the Net Resale Minus Margin is 0.15.
4.5.4 – The Use of TNMM in Practice

The TNMM is a good alternative for traditional transactional methods. With data at net profit level widely available, the fact that comparable uncontrolled transactions just have to be broadly similar, and with different net profit indicators available for usage, this method becomes broadly applicable.

The TNMM can be helpful to assess the arm’s length remuneration of low-risk routine-like manufacturing and services, but also more complicated functions such as sales or distribution. It should not come as a surprise that the TNMM is the most applied transfer pricing method.

The disadvantage of the TNMM is that in some cases, the level of comparability between controlled transaction and uncontrolled transactions can be challenged. Tax authorities sometimes raise the point. However, the general line of defense to such a position is that the TNMM is used exactly due to a lack of comparability and available information in the first place.
4.6 – Method V – The Profit Split Method

Just like the TNMM, the Profit Split Method is a transactional profit method. A transactional profit method measures the net operating profits realized from controlled transactions. It then compares this profit level to those realized by independent enterprises engaged in comparable transactions.

However, associated enterprises sometimes engage in strongly interrelated transactions. These transactions are not easily examined on a stand-alone basis, and associated enterprises commonly agree to split the profits.

The Profit Split Method examines the terms and conditions of these types of controlled transactions by determining a division of profits that independent enterprises would have agreed upon when engaging in those transactions.

**Example 32 – Profit Split Method**

In the above example, we see two joint ventures. Joint Venture I is owned by associated enterprises Y and X and undertakes a real estate development project (shopping mall). Enterprise Y brings in technical knowledge and resources for its development. Enterprise X brings in knowledge and resources for commercial exploitation. Enterprise X and Y equally share the risk of the project. There are many controlled transactions between Y, X, and Joint Venture I.

Joint Venture II is owned by independent enterprises A and B and exploits a similar shopping mall. Independent Enterprise A and Independent Enterprise B have similar functionalities to Y and X.
Let’s say that we have to determine the transfer pricing for all controlled transactions related to Joint Venture I. For that, we can inspect the allocation of profits between independent enterprises when engaging in comparable transactions. This means that we can compare Profit Split I, with Profit Split II.

4.6.1 – Two Kinds of Profit Split Methods

There are two kinds of Profit Split Methods:

1) Contribution Profit Split Method.
2) Residual Profit Split Method.

Under the **Contribution Profit Split Method**, the combined profits (the total profits from the controlled transactions under examination) are divided between the associated enterprises based upon a reasonable approximation of the division of profits independent enterprises would have expected to realize.

This division can be supported by comparables’ data where available. In the absence thereof, it is often based on the relative value of the functions performed by each of the associated enterprises, taking account of their assets used and risks assumed. In cases where the relative value of the contributions can be measured directly, it is not necessary to estimate the actual market value of each participant's contributions.

The **Residual Profit Split Method** divides the combined profits from the controlled transactions under examination into two stages:

1) In the **first stage**, each participant is allocated an arm’s length remuneration for its non-unique contributions in relation to the controlled transactions in which it is engaged. Ordinarily, this would be determined by applying one of the traditional transaction methods or a TNMM. Thus, it would not account for the return that would be generated by any unique and valuable contribution by the participants.
2) In the **second stage**, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances.

4.6.2 – Use of the Profit Split Method in Practice

The Profit Split Method is usually applied in cases where there are highly integrated controlled transactions. In these cases, there is often no clearly identifiable controlled transaction, which makes it difficult to analysis profits on a transnational basis. Examples are the set-up of a partnership, or the joint exploitation of valuable intangible assets such as brands.

A distinct disadvantage of the Profit Split Method is the subjective element of profit allocation criteria based on score cards. This often creates discussion between taxpayers and tax authorities, who might have contrasting positions on profit allocation. The Profit Split Method is not often used in practice, but is rising in popularity.

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4.7 – How to Choose the Right Method?

Following OECD Guidelines, a taxpayer should choose the most appropriate method for each particular case. Following OECD Guidelines, a taxpayer should choose the most appropriate method for each particular case.37 Most tax authorities accept the five methods, although individual countries sometimes restrict the use of a particular method.38 In practice, the TNMM remains the most popular method, followed by the CUP Method and Profit Split Method. The Cost Plus Method and Resale Margin Method are thus seldom used.

Below we discuss a few important considerations when selecting the transfer pricing method for a controlled transaction.

4.7.1 – Consideration One – Type of Controlled Transaction

The main thing to understand is the type of controlled transaction we are analyzing. Even though all five methods should be considered for a controlled transaction, in practice some methods prove more suitable than others. The below table gives a general indication on the usage of each method:

<table>
<thead>
<tr>
<th>Method</th>
<th>Type of controlled transactions</th>
<th>Example of application</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUP</td>
<td>Financing, Licensing</td>
<td>Interest rate on group loan</td>
</tr>
<tr>
<td>Resale Price</td>
<td>Distribution, Sales</td>
<td>Commission for sales agent</td>
</tr>
<tr>
<td>Cost Plus</td>
<td>(Low-risk) Services, Manufacturing</td>
<td>Mark-up for contract manufacturer</td>
</tr>
<tr>
<td>TNMM</td>
<td>Services, Distribution, Sales</td>
<td>Fee for HQ services</td>
</tr>
<tr>
<td>Profit Split</td>
<td>Joint ventures / equal sharing of risk</td>
<td>Profit split network exploitation</td>
</tr>
</tbody>
</table>

It is possible that more than one method can be used for a controlled transaction. In such a case, it is worth to do research regarding the application of the methods. For example, if you work in one of the regions of a global MNE, a colleague in another region might have dealt with the same question before.

37 OECD, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,” Para 2.2: “The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. For this purpose, the selection process should take account of the respective strengths and weaknesses of the OECD recognised methods; the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis; the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods; and the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them. No one method is suitable in every possible situation, nor is it necessary to prove that a particular method is not suitable under the circumstances.”

38 For example, on 17 March 2017, the Chinese State Administration of Taxation (SAT) issued the Bulletin on the Administrative Measures for Special Tax Investigation and Adjustments and Mutual Agreement Procedures, which provides that the transactional net margin method (TNMM) generally should not be used to determine the arm’s length profit of an enterprise with valuable intangibles.
4.7.2 – Consideration Two – Hierarchy Amongst Methods

Even though OECD Guidelines and domestic transfer pricing rules dictate that: “the taxpayer should select the most appropriate method,” there is a hierarchy among them. This hierarchy can be broken down into two rules of thumb:

**Rule 1**: Where a traditional transaction method and a transactional profit method are equally reliable, the traditional transaction method is to be preferred.

**Rule 2**: Where the CUP method and any other transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred.

4.7.3 – Consideration Three – Market Practice

Market practice shows that some methods are more popular or “user friendly” than others. These preferences even differ per country. Sometimes, local tax authorities disallow the use of a method for a particular type of transaction, or indicate a preference for the use of another. It is therefore vital to know the local market practice.

The following provides an indication of the usage and acceptance of the different methods by tax authorities:

<table>
<thead>
<tr>
<th>Method</th>
<th>Usage in practice</th>
<th>Accepted by tax authorities</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUP</td>
<td>Often</td>
<td>Only if there is a clear CUP</td>
</tr>
<tr>
<td>Resale Price</td>
<td>Seldom</td>
<td>Exceptional (unless integrated in TNMM)</td>
</tr>
<tr>
<td>Cost Plus</td>
<td>Seldom</td>
<td>Exceptional (unless integrated in TNMM)</td>
</tr>
<tr>
<td>TNMM</td>
<td>Most</td>
<td>Widely</td>
</tr>
<tr>
<td>Profit Split</td>
<td>Increasingly</td>
<td>Only for certain transactions</td>
</tr>
</tbody>
</table>

4.7.4 – Consideration Four – Financial Performance vs. Risk Appetite

It can happen that different methods applied to a controlled transaction result in different levels of taxable profits, influencing the financial performance of an enterprise. It could thus be beneficial to select a method with a more favorable outcome.

On the other hand, the choice of a more favorable method to the taxpayer could be perceived as “aggressive” by local tax authorities, and may result in a higher risk of challenges. When choosing a method, it should be considered whether an improved financial performance outweighs the risk of scrutiny from tax authorities.
**Example 33 – Choosing the right method**

Donny Digital is a service company that offers digital solutions to improve traditional sales models. The headquarters of Donny Digital is in Switzerland, but it sells its services all around the world. In larger markets, such as the United States and China, Donny Digital has set up legal entities which employ local personnel who take care of the administration of sales to existing and new clients, including invoicing duties. The local legal entities do not assume any risks on their activities.

Donny Digital wonders which method it should use for a transfer price for remunerating the local sales entities for their activities. Its initial assessment looks as follows:

<table>
<thead>
<tr>
<th>Method</th>
<th>Suitable</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUP</td>
<td>No</td>
<td>There are no comparable uncontrolled transactions.</td>
</tr>
<tr>
<td>Resale Price</td>
<td>No</td>
<td>This method requires that the sales entities assume risk on their activities. This is not the case.</td>
</tr>
<tr>
<td>Cost Plus</td>
<td>Yes</td>
<td>The Cost Plus Method is suitable for low-risk routine like activities. The activities qualify as such.</td>
</tr>
<tr>
<td>TNMM</td>
<td>Yes</td>
<td>The activities have a service nature.</td>
</tr>
<tr>
<td>Profit Split</td>
<td>No</td>
<td>There are no highly integrated operations or multiple associated enterprises making unique and valuable contributions.</td>
</tr>
</tbody>
</table>

Due to the hierarchy in transfer pricing methods (Rule 1: If a traditional transaction method and a transactional profit method are equally reliable, the traditional transaction method is to be preferred), Donny Digital takes the position that the Cost Plus method is the preferred method.

However, soon it appears that there is insufficient reliable data on comparable transactions, especially on cost levels. Donny Digital consequently decides to rely on the TNMM – Net Cost Margin, which is also in line with market practice. This changes the initial assessment:

<table>
<thead>
<tr>
<th>Method</th>
<th>Suitable</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUP</td>
<td>No</td>
<td>There are no comparable uncontrolled transactions.</td>
</tr>
<tr>
<td>Resale Price</td>
<td>No</td>
<td>This method requires that the sales entities assume risk on their activities. This is not the case.</td>
</tr>
<tr>
<td>Cost Plus</td>
<td>No</td>
<td>No reliable data available</td>
</tr>
<tr>
<td>TNMM</td>
<td>Yes</td>
<td>Selected, because of service nature, market practice and sufficient comparables available</td>
</tr>
<tr>
<td>Profit Split</td>
<td>No</td>
<td>No, there is no joint venture or equal sharing of risk</td>
</tr>
</tbody>
</table>

The application of the TNMM method shows that the transfer price should be set in such a way wherein local legal entities report an operational profit equal to their operational costs, plus a mark-up of 10%.
Chapter 5 – Transfer Pricing Documentation

This chapter first defines the objectives of transfer pricing documentation. It then examines the regular type of documentation used to substantiate the transfer price of a controlled transaction. It then introduces a unique system of Seven Building Blocks, which you can use as a template for any type of transfer pricing documentation. Lastly, it briefly discusses the Master File, Local File and Country-by-Country Reporting obligations, which are only applicable to large MNEs.

5.1 – Objectives

To understand what transfer pricing documentation tries to achieve, we first need to discuss the objectives of such documentation. The OECD distinguishes three main objectives:

Objective 1: “to ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from such transactions in their tax returns.”

In other words: it aims to create awareness and a culture of compliance. Taxpayers are thus forced to take a position regarding their transfer pricing.

Objective 2: “to provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment.”

Transfer pricing documentation can provide tax authorities with a clear overview of the activities of an enterprise that has dealings with associated enterprises. It tells them what goes on within an enterprise and whether there are risks of unacceptable transfer pricing practices. This facilitates a transfer pricing risk assessment.

Objective 3: “to provide tax administrations with useful information to employ in conducting an appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction, although it may be necessary to supplement the documentation with additional information as the audit progresses.”

The documentation can function as a blueprint for the tax authorities in case of an audit on transfer pricing practices, making such an audit much easier to undertake.

These objectives mostly facilitate the availability of relevant transfer pricing information for tax authorities.


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5.2 – Seven “Building Blocks” For Solid Documentation

The OECD has not provided extensive guidance on what must be included in transfer pricing documentation, but at a bare minimum it must consist of:

I. A description of the five comparability factors of the controlled transaction;
II. A substantiation of the choice of the transfer pricing method chosen (see previous chapter); and
III. A substantiation of the terms and conditions that have been agreed upon for the controlled transactions.

In practice, the content of documentation is highly standardized around the globe based on templates used by the Big Four Accounting Firms. Having said that, domestic legislation governs transfer pricing documentation, and obligations partly depend on the type of transaction at hand. For example, documentation for the sales of luxury goods in China is a whole different story to documentation for a loan transaction in Bermuda.

Nonetheless, it is generally advisable to structure transfer pricing documentation using these seven “Building Blocks.”

1. Executive summary
2. Introduction
3. Description of facts, controlled transaction(s) and assumptions
4. Functional analysis
5. Choice of transfer pricing method
6. Economic analysis
7. Conclusion

5.2.1 – Building Block 1 – Executive Summary

If you think that many people are interested in reading comprehensive transfer pricing documentation, you’re wrong: 99% of the readers are solely interested in its main conclusions. This makes the Executive Summary very important, since it reduces the content to its essentials. Broadly-speaking, these are:

a) What are the controlled transaction(s)?
b) What is the conclusion of the functional analysis?
c) Which transfer pricing method is used and for what reasons?
d) What is the conclusion of the economic analysis?
e) What is the transfer price? (and possible terms and conditions).

The Executive Summary should not contain different content from what is included in the rest of the documentation.

5.2.2 – Building Block 2 – Introduction

Readers appreciate it if they know what is coming and where to find relevant content. In the introduction, you can describe what is being discussed in the transfer pricing report. It
is useful to include an index with page numbers. In addition, you can create a small summary of each chapter to further signpost the information contained in the report.

5.2.3 – Building Block 3 – Facts, Controlled Transaction(s), Assumptions

The goal here is to add a detailed and complete overview of the facts, controlled transaction(s) and assumptions. Without such a clear description, it is impossible for a reader to assess the accuracy of the TPA part of the transfer pricing documentation.

First, include all information relevant to the analysis of the controlled transaction in question (step 2 of the TPA as outlined in Chapter 3). Process the information gathered into an easy-to-read format.

Next, clearly define the controlled transaction(s) under review (step 3 of the TPA).

Lastly, be clear on what is being assessed and what not. It is quite common to include a statement to limit the scope of the documentation. For example:

*The scope of this Report is limited to the following controlled transactions:*

In many cases, transfer pricing analysis is subject to assumptions. For example, it is normal to assume that all information provided for the purposes of preparing transfer pricing documentation is accurate, and no material changes to facts and circumstances occurred after the provision of the information.

5.2.4 – Building Block 4 – Functional Analysis

Functional analysis is an essential element of any TPA and transfer pricing documentation. The functional analysis covers the functions performed, assets used and risks assumed by associated enterprises in a controlled transaction. It helps the reader to understand the value creation within the supply chain in general, and the controlled transaction in particular. It offers a blueprint of the relative contributions by each associated enterprise, and their roles in overall value creation.

A functional analysis is usually performed during the TPA. Part of this process are interviews with employees – in person or through call. In the documentation, there should be a clear description of the functions performed, risks assumed and assets used with respect to the controlled transaction.

5.2.5 – Building Block 5 – Transfer Pricing Method

Transfer pricing documentation should include a description of all five common methods and an evaluation of the application of the methods for the controlled transaction. It should be clear for an interested reader, such as the tax authorities, which method has been chosen and why.

In many transfer pricing reports there is a general “copy-paste” description of transfer pricing methods, followed by a process of elimination based on “standard” reasons. The latter is not sustainable, as tax authorities can easily challenge the choice for a method.
We therefore always advise the inclusion of a detailed description on the reasons why a transfer pricing method is applicable, or why not.

<table>
<thead>
<tr>
<th>Method</th>
<th>Suitable</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUP</td>
<td>Yes/No</td>
<td><em>Detail all reasons why this method is, or isn’t suitable</em></td>
</tr>
<tr>
<td>Resale Price</td>
<td>Yes/No</td>
<td><em>Detail all reasons why this method is, or isn’t suitable</em></td>
</tr>
<tr>
<td>Cost Plus</td>
<td>Yes/No</td>
<td><em>Detail all reasons why this method is, or isn’t suitable</em></td>
</tr>
<tr>
<td>TNMM</td>
<td>Yes/No</td>
<td><em>Detail all reasons why this method is, or isn’t suitable</em></td>
</tr>
<tr>
<td>Profit Split</td>
<td>Yes/No</td>
<td><em>Detail all reasons why this method is, or isn’t suitable</em></td>
</tr>
</tbody>
</table>

5.2.6 – Building Block 6 – Economic Analysis

Based on the foregoing Building Blocks, a taxpayer should have a good idea of what comparable uncontrolled transactions look like and which method to use. The next step is to perform an economic analysis.

The economic analysis addresses the five comparability factors (details below). These factors are considered for the purposes of making comparisons between controlled and uncontrolled transactions. If there are differences, and these cannot be solved with comparability adjustments, then there is no comparability. An uncontrolled transaction then disqualifies as “comparable.”

Part of the economic analysis is the search for data on the comparable uncontrolled transactions (benchmarking). This data, if sufficient and of good quality, helps to determine the transfer pricing to be applied on the controlled transaction. Do not forget to subject the data to the process mentioned in Chapter 3.9, resulting in middle, upper and lower quartiles.

**The Five Comparability Factors**

As mentioned, a test of the five Comparability Factors should be included in the documentation. These are the following: 40

1) The contractual terms of the transaction.
2) The functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including 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.
3) The characteristics of property transferred or services provided.
4) The economic circumstances of the parties and of the market in which the parties operate.
5) The business strategies pursued by the parties.

For clarity, a table similar to the one shown in Chapter 5.2.5 above could be applied to clearly summarize all relevant facts and considerations.


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5.2.7 – Building Block 7 – Conclusion

The part is similar to the Executive Summary. Here, repeat all significant conclusions, adding any details and possible limitations to the scope of the report if needed. It is important that the conclusion does not contain content not mentioned in the rest of the report.

5.3 – Documentation and Compliance for Large MNEs

The type of documentation discussed above concerns “regular” transfer pricing documentation that applies to the controlled transaction of most MNEs. Large MNEs\(^\text{41}\) are also obliged to prepare two additional types of documentation, and to comply with reporting requirements related to transfer pricing:

The **Master File** is intended to provide a high-level overview of the dealings of an MNE on a global scale. With this information, tax authorities have an overview of the economic, legal, financial and tax arrangements of a MNE. This gives them a good idea if any risks exist.

The **Local File** goes more into detail and looks at controlled transactions of an individual taxpayer that are relevant for the local tax authority involved. The Local File contains relevant financial data, like the transfer prices used, and the method chosen to calculate them. Where the Master File secures the general overview, the Local File reveals how the controlled transactions happen at arm’s length terms and conditions.

The **Country-by-Country Report** is a mandatory high-level report for large MNEs with a turnover of USD 750m or more per year. It describes the global allocation of income, taxes paid, and the location of economic activity among the jurisdictions in which the MNE operates. In addition, a list of legal entities forming the group is added, as well as information about their jurisdiction of incorporation and residence status.

In **Annex I** you can find more detailed information on these types of documentation.

5.4 – Timing for preparation

There is no standard period for preparing transfer pricing documentation. Some countries demand information to be ready at the time a tax return is filed. Other countries want to see it ready at the time of audit.

However, the aim of transfer pricing rules and documentation obligations is to actively apply the arm’s length principle by calculating the correct transfer price before the actual transactions take place. Logically, this means that transfer pricing documentation should be built during the year as transactions occur, rather than at the end of the financial year, as you would do for other types of reporting (like statutory accounts).

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\(^{41}\) These obligations are dictated by domestic legislation. Usually, there is a revenue threshold that must be met.
Such an approach results in what is known as “contemporaneous documentation.” Unsurprisingly, for many countries, maintaining contemporaneous transfer pricing documentation is the standard. If such a requirement exists, a taxpayer should be able to substantiate all controlled transactions for the taxpayer under examination the moment an information request is received.

And so is the creation of documentation an ongoing process. A transfer pricing professional should therefore maintain an active position within the MNE.
Chapter 6 – How To Implement A Transfer Pricing Policy

Once the TPA and transfer pricing documentation are ready, it is time to formulate the transfer pricing policy. The challenge: how to integrate the policy into the business operations? And, taking it even further: how to ensure that the policy is complied with?

Don’t take this lightly; a transfer pricing policy does not add any value if it is not actively followed. Below, we discuss some necessary considerations for implementing a policy:

1) Involving stakeholders
2) Ensuring data quality
3) Process formalization
4) Transfer pricing agreements

6.1 – Policy Implementation I – Involve Stakeholders

Within MNEs, the preparation of the transfer pricing policy and documentation is often done by the in-house tax department or outsourced to an external transfer pricing advisor. The actual implementation, however, relies on the MNE’s management, and finance and legal departments.

The involvement of management is vital, as the implementation of a policy can affect the financial performance of the business.

Example 32 – Transfer pricing and financial performance

John is working as Head of Operations for Enterprise A. Enterprise A is owned by Enterprise B. John is entitled to an annual bonus if he meets certain Key Performance Indicators (KPIs). This is important to him. One of these KPIs is the Earnings Before Interest and Taxes (EBIT) of Enterprise A.

In 2018, Enterprise B implements a transfer policy for management services rendered to Enterprise A. The subsequent charges negatively affect the EBIT. John is very disappointed as his bonus is cut in half, and he quits in anger. Such a situation could have been avoided by having a discussion before implementing the policy. In this case, the financial effects should have been made clear, alongside the potential risks of not complying. Perhaps John could have been offered some type of compensation.

Next, it would be advised to involve the Finance Department, as they are the ones responsible for reporting the policy in books and tax returns. The Finance Department is also responsible for invoicing and the collection of inter-company charges. Thus, they are in the perfect position to oversee policy implementation.

Example 33 – Transfer pricing and financial reporting

Berry is working as Regional Controller Africa for the X Group, which is an MNE in the fashion industry. Marco works as Tax Director of the X Group, and is based in its head-office in the United Kingdom. Marco has designed a new transfer pricing model,
under which operating entities as of 1 January 2018 are charged with an annual royalty fee for the use of the famous brands owned by the X Group. Marco should inform Berry before 1 January 2018, so that Berry:

I. Can include the royalty fee in the financial forecasting for 2018.
 II. Implement processes to ensure that royalty fees are paid on time and reported accordingly in local tax returns.

By informed on time, Berry can also provide feedback on potential challenges and risks regarding the new royalty fee.

The Legal Department should also be involved. Firstly, you should know whether there are any legal issues with the implementation of your policy. For example, some countries have strict rules on international bank transfers. Moreover, the policy must be formalized in agreements, making the Legal Department’s involvement essential. We discuss transfer pricing agreements in more depth in section 6.4.

6.2 – Policy Implementation II – Ensuring Data Quality

The successful implementation of a transfer pricing policy also relies on having the right data available. This ranges from basic legal information, such as legislation in specific countries and the name of the legal entity receiving the invoice, to financial information, such as the calculation of the invoice amount.

Faulty or missing data can seriously jeopardize the policy’s goal by incorrectly allocating income and expenses among associated enterprises. Quality assurance of data is therefore essential.

Example 34 – Use of Data

Matt, Director of Transfer Pricing for a MNE, proposes a change to the transfer policy for the charge of royalty fees by the MNEs headquarters to associated enterprises. In the past, the royalty fee was a lump sum amount based on number of employees. He proposes changing the royalty fee to 3% on the annual “net revenues” as reported in the statutory annual accounts. However, it turns out that in one country where the MNE is active, in this case China, there is no such thing as “net revenues” in the statutory annual accounts. The necessary data will not be available and it will be problematic to calculate the royalty fee for the Chinese associated enterprises.

Data quality has become even more crucial as tax authorities around the world are investing heavily in qualified data professionals and technology to scrutinize the immense amount of information they’re collecting from taxpayers – on transfer pricing in particular. Their data analysis is particularly focused on mismatches between various sources of information. For example, tax authorities compare numbers in tax returns with numbers in financial statements and other reports (Country-by-Country, Local File, Master File). Taxpayers are expected to keep up with technological developments by implementing solutions and processes to get data quality assurance, or risk having their transfer pricing challenged.
6.3 – Policy Implementation III – Formalize the Process

Only continuous compliance secures the success of a transfer pricing policy. Most MNEs have Compliance, Internal Audit and Risk Management departments checking whether compliance conditions are being met. They monitor the processes in place and observe whether these conditions are actively pursued.

It's therefore best to formalize the policy in a written process, and summarize all actions required to comply with it, the departments/functions involved, as well as time frames and deadlines. When writing the process, it's good to involve stakeholders at an early stage to obtain their buy-in and awareness.

6.4 – Policy Implementation IV – Transfer Pricing Agreements

Transfer pricing arrangements between associated enterprises must be formalized in agreements. This gives the associated enterprises involved certainty on what has been agreed upon and leaves an audit trail to confirm what has happened. This helps to easily substantiate terms and conditions for controlled transactions in the case of an audit.

The actual content of transfer pricing agreements depends on the type of controlled transaction. Certain complicated transactions, such as IP licensing, need very detailed agreements. Other transactions, such as management fees, can be formalized with simple agreements. Having said that, there are standard aspects to be included in any transfer pricing agreement.

We discuss eight points:

1. Parties.
2. Considerations.
3. Controlled transaction
4. Arm’s length remuneration.
5. Term
6. Taxes
7. Amendments
8. Governing law and Jurisdiction.

6.4.1 – Point 1 – Parties

Which associated enterprises are a party to the agreement? In most cases, it will be just two parties, but there may be multiple parties. An example is the transfer of an internal loan from one associated enterprise to another: most law systems require the existing creditor, new creditor, and the debtor to be party to such an agreement.

6.4.2 – Point 2 – Considerations

It is prudent to include considerations for entering into the agreement as this lays down the intention of the parties. This not only allows this a third-party to understand the agreement, it also helps to avoid disputes between the associated enterprises on its context.
Considerations do not always have the same legal force as the articles of an agreement; these depend on the governing law of the agreement alongside other applicable laws.

The considerations of an agreement are usually referred to as ‘Whereas’.

6.4.3 – Point 3 – Controlled Transaction

There are numerous controlled transactions ranging from providing a group loan up to supplying goods. And often there are multiple controlled transactions at the same time. Hence, it is advisable to clearly isolate one or more transactions in the agreement. Try to be as specific as possible.

Example 35 – Defining the transaction

Kebab King US is a famous global chain of Kebab restaurants. Kebab King Europe exclusively owns the rights to exploit the trade name and restaurant formula “Kebab King” in Europe. Kebab King Austria wishes to set-up a new Kebab King restaurant in Austria where demand for Kebabs is skyrocketing. Kebab King Austria needs an exclusive license from Kebab King Europe to do so. Kebab King Europe and Kebab King Austria are advised to conclude a transfer pricing agreement in the form of a licensing agreement.

The controlled transaction to be included in the agreement can be:

Kebab King Europe will license the brand rights and restaurant formula “Kebab King” to Kebab King Austria – which is technically correct.

However, it is better to say:

Kebab King Europe, which exclusively owns the rights to exploit the trade name and restaurant formula “Kebab King” in Europe, will grant an exclusive license to Kebab King Austria to use the trade name and restaurant formula “Kebab King” in Austria only.

This avoids any discussions down the road on the exclusivity and the country of the license granted to Kebab King Austria.

To further specify matters, it is also possible to add to the agreement what the controlled transaction does not resemble (exclusions). Going back to the example:

Kebab King Europe, which exclusively owns the rights to exploit the trade name and restaurant formula “Kebab King” in Europe, will grant an exclusive license to Kebab King Austria to use the trade name and restaurant formula “Kebab King” in Austria.

...For the avoidance of doubt, Kebab King Europe does not, and will not grant to Kebab King Europe any license to use the trade name and restaurant formula “Kebab King” outside of Austria.
6.4.4 – Point 4 – Arm’s length remuneration

Clearly describe the arm’s length remuneration based on the transfer pricing analysis. It is advisable to include the transfer pricing method used to determine the arm’s length remuneration. Also, the calculation of the arm’s length remuneration should be clear.

Example 36 – Arm’s length remuneration

The conclusion of a transfer pricing analysis is that the arm’s length remuneration for administrative services equals the costs attributable to the provision of the administrative services as well as a mark-up of 5%. In the agreement, you can simply include:

*The arm’s length remuneration for the services is cost + 5%.*

However, this leaves uncertainty on the transfer pricing method used. It is therefore better to include:

*The arm’s length remuneration of the administrative support services has been determined based on the cost plus method and is equal to the costs attributable to the provision of the administrative services + a mark-up of 5%.*

6.4.5 – Point 5 – Term of Contract

When the agreement begins and when it ends must be clear. In principle, there is no limitation for agreements, but it is advisable to look at market practice regarding the term. For example, if the standard lease term for an office building is six years, it would make sense to agree the same for a controlled lease transaction unless there is a clear reason not to do so.

6.4.6 – Point 6 – Tax

Payment of remuneration for a controlled transaction can result in taxation – withholding tax on the payment of a royalty fee, for example. The agreement must be clear on which party is paying these taxes. If the remuneration is tax-exclusive, confirm that the remuneration must be paid in cleared funds, without any deduction or offset of any taxes, levies, imports, duties, charges, fees and withholdings. If the remuneration is tax-inclusive, confirm that the remuneration must be made after deduction or offset of any taxes, levies, imports, duties, charges, fees, and withholdings.

6.4.7 – Point 7 – Amendments

Facts and circumstances can change and this can call for amendments to the agreement. An example is an updated transfer pricing analysis showing a different arm’s length remuneration. The agreement should include instructions for its amendment. For example, only by agreement in writing.
6.4.8 – Point 8 – Governing Law and Jurisdiction

The choice of governing law for the agreement is important. This comes especially if the associated enterprises involved are based in a jurisdiction where there is no real rule of law, or law enforcement is time-consuming. The same goes for what is being agreed upon as the court handling any disputes under the agreement (jurisdiction).

Example 37 – Governing law

An associated enterprise based in Singapore makes a controlled transaction with an associated enterprise in Myanmar. In Singapore there is a highly efficient and trustworthy law system. In Myanmar, the legal system is dysfunctional. In such a case, it is highly recommended to use Singapore law as governing law and a court in Singapore to resolve any disputes under the agreement. This becomes even more important if the controlled transaction in question demands specific technical knowledge, such as an IP licensing agreement.
Chapter 7 – Transfer Pricing Disputes

The number of transfer pricing disputes is increasing. Starbucks, Amazon, Apple, Facebook, McDonald's are just a few examples of the many MNEs that are, or have been, subject to disputes around the world. Moreover, the counter-parties of these disputes are not just tax authorities, but also supranational organizations, such as the European Union. And it is not just large-listed MNEs that face scrutiny. Smaller MNEs are subjected to the same legislation after all.

This chapter first discusses the nature of disputes. It then presents a summary of the most common dispute areas, before moving on to a list of five measures you can take to limit your risk on a transfer pricing dispute.

7.1 – Nature of disputes

Most transfer pricing disputes stem from different positions regarding the terms and conditions for controlled transactions. If the tax authorities do not accept the agreed terms and conditions, they will try to amend them to be in line with their own transfer pricing rules and policies, thus affecting the taxable profits of the associated enterprises involved. Taxpayers, on the other hand, could object to the amended terms and conditions.

The way disputes are settled depends on local legislation. In some countries, such as the Netherlands, there are formal procedures that need to be followed before a case can go to court. In other countries, going to court is the only way a dispute can be resolved.

A dispute on a domestic controlled transaction is normally not a big deal. In such a case, an adjustment to the terms and conditions of one associated enterprise, is easily mirrored by an adjustment at the other associated enterprise.

This does not apply to international controlled transactions however, where an adjustment made by one tax authority can result in a discussion with another tax authority. Amongst other things, this depends on whether there is a double-tax treaty in place.

7.2 – Common dispute areas

In theory, every transfer price is open for debate, thus a dispute is always a possibility. Certain business practices and controlled transactions however bear a higher risk of disputes than others.

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42 There are no exact numbers on transfer pricing disputes around the world. However, there are websites that register transfer pricing cases, like: https://tpcases.com/. On this website (be careful, their summaries are not always correct), you can see a significant increase in the amount of cases registered since 2015. This corresponds with information on other sites, and our personal observations.
7.2.1 – Dispute Area 1 – Business Restructurings

In the corporate world, a “business restructuring” means the act of reorganizing the legal, ownership, operational, or other structures of a business for the purpose of making it more profitable, or better organized for its present needs. Examples are:

1. The integration of a new business into an existing organization;
2. The centralization of a procurement function; and
3. Outsourcing manufacturing activities to low-cost countries.

Restructuring customarily involves the transfer of assets, functions and risks from one associated entity to another. A restructuring can thus result in “visible,” and “invisible” controlled transactions. In both cases, there can be consequences for the transfer pricing, and thus an increased risk of a dispute.

**Example 38 – Restructuring:**

Whiskey & Rocks UK, based in the UK, produces and sells alcoholic beverages in Europe through local legal entities, including Italian-based legal entity Whiskey & Rocks Italy. Until 1 January 2018, Whiskey & Rocks Italy was operating as a stand-alone business responsible for the production and sales of alcoholic beverages in Italy, as well as the assumed risks in relation to these activities (full-fledged manufacturer).

Taking effect from 1 January 2018, the sales activities and risks related to production and sales are transferred to Whiskey & Rocks UK. Whiskey & Rocks Italy continues its production activities but assumes only limited risks – on the procurement of raw materials (contract manufacturer), for example.

Due to the change of business model, Whiskey & Rocks Italy has transferred certain intellectual property (IP), such as client lists and local marketing knowhow to Whiskey & Rocks UK. However, no remuneration has been paid by Whiskey & Rocks UK in relation to this transfer. Also, the transfer pricing model has not been adjusted to the change of the business model.

In this case, there is a high risk of a dispute between Whiskey & Rocks UK and the Italian tax authorities. First of all, the Italian tax authorities could challenge Whiskey & Rocks UK for not paying a remuneration for the transfer of IP assets by Whiskey & Rocks Italy. Accordingly, the Italian tax authorities could make a valuation of these IP assets and adjust the taxable income for Whiskey & Rocks Italy with an according amount. Penalties and fines could also be added. Secondly, the Italian tax authorities could challenge the transfer pricing model if the controlled transactions have changed.

7.2.2 – Dispute Area 2 – Management fees

Typically, within an MNE, certain corporate functions, such as general management (e.g. CEO, CFO), legal and finance are centralized in its headquarters. The location of this headquarters is often the country where the MNE is listed on the stock exchange.
When performing centralized corporate functions, MNEs incur huge costs. Transfer pricing rules ordinarily allow the recharging of these costs\(^{43}\) to the operational entities of the MNE as “management fees” (or “service fees”). Accordingly, operational entities are confronted with these fees. This often results in resistance as they affect their financial performance.

Tax authorities in certain countries also have resistance in allowing operational entities a deduction in fees, as this lowers their taxable profit and according tax collection. Brazil, China and India are among the countries known to have a critical attitude towards deduction of management and service fees. MNEs should thus think carefully about the management fee policy before charging these fees out to operational entities:

**Example 39 – Management fees**

X Group sells mobile phones in Asia. X Group’s headquarters are in the Philippines and take care of all corporate functions. X Group has subsidiaries in most Asian countries which only take care of local sales. X Group charges its subsidiaries management fees. The management fees are equal to its operational costs, plus a mark-up of 10%. This total fee is then allocated among the different subsidiaries based on their Net Revenues.

In financial year 2018, all subsidiaries deduct the management fee for local tax purposes. The Chinese tax bureau argues that the management fee does not directly or indirectly provide economic benefits to X China, and thus the “benefit test” is not met. Accordingly, the management fee is non-deductible. As this would result in a higher taxable profit and higher tax due, X China may object.

...and a dispute is born.

**7.2.3 – Dispute Area 3 – Intangible assets**

Controlled transactions involving intangible assets receive a lot of scrutiny from tax authorities. And this is not without reason. As opposed to fixed assets such as factories and inventory, intangible assets can be easily transferred within an MNE. Hence, it is easier to allocate revenues of these types of assets to an associated entity in a low-tax country. This form of profit shifting is something tax administrations do not want, and the OECD sets out to constrain.

According to the OECD, legal ownership as such is not sufficient to allocate revenues of intangible assets. In short, a legal owner of an intangible will only be entitled to all profits derived from the exploitation of the intangible if he in substance:

1. Performs and controls all of the functions related to the development, enhancement, maintenance, protection and exploitation of the intangible.
2. Provides all assets, including the funding necessary for the development, enhancement, maintenance, protection and exploitation of the intangible.

\(^{43}\) Except for costs for so-called “shareholder activities”
3. Bears and controls all the risks related to the development, enhancement, maintenance, protection and exploitation of the intangible.\textsuperscript{44}

In case the specified functionality is not present, tax authorities can try to adjust the terms and conditions of controlled transactions. These adjustments can be significant, especially when businesses are concerned for which intangible assets are an important value driver, such as luxury fashion brands.

\textbf{7.3 – Avoiding disputes}

Besides lawyers, no one likes transfer pricing disputes. Disputes create uncertainty, cost money, and take time to resolve. So we all try to avoid them.

Before informing you on how to best avoid transfer pricing disputes, it is worth mentioning that there is no way to ensure you will not run into them. Transfer pricing is a “Battle of Opinions,” and the outcome is \textit{always} open to interpretation.

Moreover, there are too many factors out of your control, such as the evolving transfer pricing policies of local tax authorities or the CFO’s appetite for risk. Thus, you can only try to reduce the risk of a dispute. Here are five measures you can implement:

\textbf{7.3.1 – Dispute Avoiding Measure 1 – Solid Documentation}

Without proper substantiation of transfer prices, you open the door to a dispute. It allows tax authorities and other potential counterparts to force their own views on the situation, which are not necessarily beneficial.

On the contrary, well-prepared, and substantiated documentation enables you to defend your transfer pricing policies. It is then up to the counter-party to demonstrate that the transfer pricing is not in line with the rules, which is far more difficult.

\textbf{7.3.2 – Dispute Avoiding Measure 2 – Timely Compliance}

As a taxpayer, you do not want to give authorities a stick to hit you with. Non-compliance or a non-timely compliance often results in a visit/audit from the authorities.

During an audit/visit, authorities often request a large amount of information to assess the tax position. This can be costly and time-consuming. Therefore, it is of paramount importance that all local transfer pricing and tax compliance stipulations are met in time. Examples of such compliance requirements are Country-by-Country Reporting, but also corporate tax returns.

\textbf{7.3.3 – Dispute Avoiding Measure 3 – Relationship with the tax authorities}

It is common sense, but often forgotten: develop a good relationship with the authorities. Until tax collection is fully automated, if ever, your counterpart at the tax authorities will be a human being. And we as human beings tend to be nicer to the people we know and like.

\textsuperscript{44} OECD, “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,” Para. 6.71
So invest some time to get to know your counterpart(s) at the tax authorities and maintain a good relationship. It also helps you to defend your position better.

7.3.4 – Dispute Avoiding Measure 4 – Non-Aggressive Positions

As mentioned before, one of the explanations for the high level of disputes is that tax authorities perceive MNEs to use transfer pricing as an instrument to reduce their overall tax liability. Whether true or not, this is a fact that you must be aware of.

In that light, aggressive transfer pricing positions do not help to avoid disputes. It is better to stay on middle ground. An example is not using the lower or upper quartile values in favor of the median value (unless you have a good explanation).

7.3.5 – Dispute Avoiding Measure 5 – Advance Pricing Agreements

An effective way of avoiding transfer pricing disputes with tax authorities is to conclude an Advance Pricing Agreement (APA). An APA is an ahead-of-time agreement between one or more taxpayers and a tax authority regarding the terms and conditions for one or more controlled transactions for a fixed period.

**Content of an APA**

In general, a taxpayer and tax authority would agree upon the following subjects in an APA:

- Transactions covered by the APA
- The transfer pricing method applied
- The term of the APA
- Operational and compliance provisions
- Appropriate adjustments
- Critical assumptions regarding future events
- Required APA records
- Annual compliance reporting responsibility

**Bilateral vs. unilateral APAs**

Unilateral APAs involve agreements between only the taxpayer and one tax authority. However, taxpayers can enter into APAs with more than one tax authority, known as bilateral or multilateral APAs. Multilateral APA’s can be done through the Mutual Agreement Procedure (MAP), included in most income tax treaties.

**APAs for small business taxpayers**

Some APA programs allow small business taxpayers (SBT) to obtain the compliance certainty of an APA at a cost relative to the size and complexity of the transactions involved. SBT APAs are typically unilateral, but can also be bilateral.
**Advantages vs disadvantages of an APA**

The main advantage of an APA is that it establishes maximum certainty on the transfer pricing position for the taxpayer in relation to particular transaction(s) and thus reduces the chance of a dispute to almost zero. The other main advantage is that when concluding an APA with the tax authorities, an open dialogue is possible (as opposed to an audit environment).

It's worth considering however that the APA makes it difficult to change the business model during the term in which it is in force, as the arm's length pricing agreed is based on that business model. Also, obtaining an APA is far from cheap, and only makes sense if the numbers of a controlled transaction are substantial.

Following the BEPS Action Plan, the OECD advised its Member Countries to adopt a standardized approach to transfer pricing documentation for large MNEs in the form of a three-tiered structure consisting of the:

1. Master File, containing standardized information relevant for all MNE group members;
2. Local File, referring specifically to material transactions of a local taxpayer; and the
3. Country-by-Country Report, containing certain information relating to the global allocation of the MNE’s income and taxes paid, together with certain indicators of the location of economic activity within the MNE group.

In this section, we clarify these three items further. This information is based on the publications by the OECD on this subject. Please note that this guidance is for reference only, and should not be considered professional advice. We advise you to always verify domestic rules on documentation and reporting requirements.

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1. The Master File

As per the OECD, the Master File should provide an overview of the MNE’s business, including the nature of its global business operations, its overall transfer pricing policies, and its global allocation of income and economic activity. This information allows tax administrations to easily evaluate the presence of transfer pricing risks.

The Master File is intended to provide a high-level overview, in order to place the MNE group’s transfer pricing practices in their global economic, legal, financial and tax context. The Master File thus functions as a “blueprint” of the MNE group.

The information required can be grouped in five categories:

a) The MNE group’s organizational structure;
b) A description of the MNE’s business or businesses;
c) The MNE’s intangibles;
d) The MNE’s intercompany financial activities; and
e) The MNE’s financial and tax positions.

What information must be included in the Master File?

Below we list the information that must be included in the Master File.

A. Organizational structure

A chart illustrating the MNEs legal and ownership structure and geographical location of operating entities.

B. Description of the MNE's business(es)

A general written description of the MNE's business including:

- Important drivers of business profit.
- A description of the supply chain for the group’s five largest products and/or service offerings by turnover plus any other products and/or services amounting to more than 5 percent of group turnover. The required description could take the form of a chart or a diagram.
- 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 capabilities of the principal locations providing important services and transfer pricing policies for allocating services costs and determining prices to be paid for intra-group services.
- A description of the main geographic markets for the group’s products and services that are referred to in the second bullet point above.

47 Ibid., Par. 18, 19
48 Ibid., from Annex I, until Chapter V
• A brief written functional analysis describing the principal contributions to value creation by individual entities within the group, i.e. key functions performed, important risks assumed, and important assets used.
• A description of important business restructuring transactions, acquisitions and divestitures occurring during the fiscal year.

C. On the MNE’s intangibles
• 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.
• A list of intangibles or groups of intangibles of the MNE group that are important for transfer pricing purposes and which entities legally own them.
• A list of important agreements among identified associated enterprises related to intangibles, including cost contribution arrangements, principal research service agreements and licence agreements.
• A general description of the group’s transfer pricing policies related to R&D and intangibles.
• A general description of any important transfers of interests in intangibles among associated enterprises during the fiscal year concerned, including the entities, countries, and compensation involved.

D. On the MNE’s inter-company financial activities
• A general description of how the group is financed, including important financing arrangements with unrelated lenders.
• The identification of any members of the MNE group that provide a central financing function for the group, including the country under whose laws the entity is organized and the place of effective management of such entities.
• A general description of the MNE’s general transfer pricing policies related to financing arrangements between associated enterprises.

E. On the MNE’s financial and tax positions
• The MNE’s annual consolidated financial statement for the fiscal year concerned 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 (APAs) and other tax rulings relating to the allocation of income among countries.
When to prepare the Master File?

The OECD has not provided thresholds for the preparation of the Master File. Therefore, you should always check domestic rules to confirm whether the preparation of a Master File is required.

Does the Master File have to be filed?

In most countries MNEs are required to maintain the Master File in their administration and provide it to the tax authorities upon their request only. However, in certain countries there is an actual filing obligation. Please check domestic rules to confirm.

Attention Points When Preparing the Master File

When preparing the Master File, it is advisable to take into account the following attention points:

- Make sure that the Master File is consistent with the Local File and any other transfer pricing documentation to avoid questions from local tax authorities.
- Make sure that the Master File is available in time, to avoid fines and penalties.
- Make sure to update financial information annually.
- Make sure that the Master File is consistent with other financial information such as annual accounts.
2. The Local File

Where the Master File provides a high-level overview, the Local File examines a specific taxpayer and its controlled transactions. The information required in the Local File supplements the Master File. It helps to meet the OECD’s objective of assuring that the taxpayer has complied with the arm’s length principle in the material transfer pricing positions affecting its specific jurisdiction.

The Local File focuses on information relevant to the transfer pricing analysis related to transactions taking place between a local country affiliate, and associated enterprises in different countries. Such information would include: relevant financial information regarding those specific transactions, a comparability analysis, and the selection and application of the most appropriate transfer pricing method.49

What information must be included in the Local File?

Below are more details on the information to be included in the Local File.50 The Local File contains relevant information that can be grouped into three categories:

   a) Local entity
   b) Controlled transactions
   c) Financial information

A. On the Local entity

   • 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(ies) in which such individuals maintain their principal offices.
   • A detailed description of the business and business strategy pursued by the local entity including an indication whether the local entity has been involved in or affected by business restructurings or intangibles transfers in the present or immediately past year and an explanation of those aspects of such transactions affecting the local entity.
   • Key competitors.

B. On Controlled transactions

   For each material category of controlled transactions in which the entity is involved, provide the following information:

   • A description of the material controlled transactions (e.g. procurement of manufacturing services, purchase of goods, provision of services, loans, financial and performance guarantees, licenses of intangibles, etc.) and the context in which such transactions take place.

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49 Ibid., Par. 22. Please note that where a requirement of the Local File can be fully satisfied by a specific cross-reference to information contained in the Master File, such a cross-reference should suffice.

50 Ibid., from Annex II, until Chapter V
The amount of intra-group payments and receipts for each category of controlled transactions involving the local entity (i.e. payments and receipts for products, services, royalties, interest, etc.) broken down by tax jurisdiction of the foreign payor or recipient.

An identification of associated enterprises involved in each category of controlled transactions, and the relationship amongst them.

Copies of all material intercompany agreements concluded by the local entity.

A detailed comparability and functional analysis of the taxpayer and relevant associated enterprises with respect to each documented category of controlled transactions, including any changes compared to prior years.

An indication of the most appropriate transfer pricing method with regard to the category of transaction and the reasons for selecting that method.

An indication of which associated enterprise is selected as the tested party, if applicable, and an explanation of the reasons for this selection.

A summary of the important assumptions made in applying the transfer pricing methodology.

If relevant, an explanation of the reasons for performing a multi-year analysis.

A list and description of selected comparable uncontrolled transactions (internal or external), if any, and information on relevant financial indicators for independent enterprises relied on in the transfer pricing analysis, including a description of the comparable search methodology and the source of such information.

A description of any comparability adjustments performed, and an indication of whether adjustments have been made to the results of the tested party, the comparable uncontrolled transactions, or both.

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.

A summary of financial information used in applying the transfer pricing methodology.

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 controlled transactions described above.

C. Required financial information

Annual local entity financial accounts for the fiscal year concerned. If audited statements exist they should be supplied and if not, existing unaudited statements should be supplied.

Information and allocation schedules showing how the financial data used in applying the transfer pricing method may be tied to the annual financial statements.

Summary schedules of relevant financial data for comparables used in the analysis and the sources from which that data was obtained.
Are all MNEs required to prepare a Local File?

The OECD has not set forth thresholds for the preparation of a Local File. You should check domestic rules as to whether the preparation of a Local File is required.

Does the Local File have to be filed?

In most countries, MNEs are required to maintain the Local File in their administration and provide it to the tax authorities upon request. However, in certain countries there is an actual filing obligation. Please check domestic rules to confirm this.

Important points for Preparing the Local File

When preparing your Local File, it is advisable to take the following into account:

• Make sure that the Local File is consistent with the Master File, and any other transfer pricing documentation to avoid questions from local tax authorities.
• Make sure that the Local File is available in time to avoid fines and penalties. The idea of transfer pricing documentation is to keep it up-to-date. It should not be prepared at the end of the year, like annual accounts – or worse, when asked for it by the authorities.
• Make sure to update the financial information annually.
• Make sure that the Local File is consistent with financial information, such as annual accounts.
3. Country-by-Country Reporting

Country-by-Country Report (CbCR) forces transparency upon large MNEs. It shows tax administrations around the world how they generate profits, in which jurisdictions they report them, and how much taxes they pay on those profits.

The aim is to discourage the shifting of profits from high-tax jurisdictions, to low-tax jurisdictions (without justification). In short, profit allocation requires substantial activities (substance). The CbCR provides valuable insights in this because it summarizes the MNE’s actual activities.

The CbCR requires large MNEs to provide aggregate jurisdiction-wide information relating to the global allocation of income, taxes paid, and economic activity among jurisdictions in which it operates. The report also requires a listing of all the Constituent Entities\textsuperscript{51} for which financial information is reported, including the jurisdiction of incorporation (and residence), as well as the nature of the main business activities carried out by that Constituent Entity.\textsuperscript{52}

CbCR obligations only apply to large MNEs with an annual consolidated group revenue in the immediately preceding fiscal year of more than USD 750m.

What should be included in the CbCR?

In the CbCR MNEs should report per tax jurisdiction in which they are active:

- Revenue
- Profits before income tax
- Income paid and accrued,
- Total employment
- Capital
- Retained earnings
- Tangibles assets

\textsuperscript{51} Ibid., based on the General Instructions for Annex III to Chapter V:
A Constituent Entity of the MNE group is:
(i) any separate business unit of an MNE group that is included in the Consolidated Financial Statements of the MNE group for financial reporting purposes, or would be so included if equity interests in such business unit of the MNE group were traded on a public securities exchange;
(ii) any such business unit that is excluded from the MNE group’s Consolidated Financial Statements solely on size or materiality grounds; and
(iii) any permanent establishment of any separate business unit of the MNE group included in (i) or (ii) above provided the business unit prepares a separate financial statement for such permanent establishment for financial reporting, regulatory, tax reporting, or internal management control purposes.

\textsuperscript{52} Ibid., Par 24 and 25
Please note that OECD has developed specific templates for the CbCR and provided detailed instructions on how to complete these templates. It goes beyond the scope of this Annex to discuss the template and instructions in details. We kindly refer to the OECD publications for further reading.\textsuperscript{53}

**How and when to file the CbC Report?**

Many countries implemented legislation under which the MNEs “Ultimate Parent Entity” is responsible for filing the CbC Report annually in its home jurisdiction. The Ultimate Parent Entity is a Constituent Entity that meets the following criteria:

(i) its owns directly or indirectly a sufficient interest in one or more other Constituent Entities and is required to prepare Consolidated Financial Statements under accounting principles generally applied in its jurisdiction of tax residence, or would be so required if its equity interests were traded on a public securities exchange in its jurisdiction of tax residence.

(ii) there is no other Constituent Entity of such MNE Group that owns directly or indirectly an interest described in subsection (i) above in the first mentioned Constituent Entity.

In case of failure of filing, in case the Ultimate Parent Entity is not obliged to file the CbC Report in its home jurisdiction, or in cases where the CbCR is effectively not shared by the tax administration of the MNE’s Ultimate Parent Company, each Constituent Entity shall be obliged to file the CbC Report. This is only different if a qualifying replacement (Surrogate Parent Entity) has been appointed by the MNE group as a sole substitute for the Ultimate Parent Entity.

Most countries require that the CbC Report is filed no later than twelve months after the last day of the year (consolidated reporting period for financial statement purposes) to which the CbCR relates.

**Data used in the CBC Report**

Sources of data should be used consistently from year to year when completing the CbCR template. The MNE can choose to use data from its consolidation reporting packages, from separate entity statutory financial statements, regulatory financial statements, or internal management accounts.


It is not necessary to reconcile the revenue, profit and tax reporting in the template to the consolidated financial statements. The MNE should provide a brief description of the sources of data. If a change is made in the source of data used from year to year, the MNE should explain the reasons for the change and its consequences.

**Sharing of CbCR Reports between tax administrations**

Tax administrations are expected to automatically exchange the CbC Reporting with jurisdictions that have also implemented CbCR requirements, and have ascertained the confidentiality thereof in their legislation. The legal basis for this exchange of information can be bilateral, or multilateral treaties.

**Are there sanctions for not filing a CbCR?**

The OECD model legislation does not include provisions regarding penalties to be imposed if a MNE fails to comply with CbC Reporting requirements. This will be up to the jurisdictions implementing these requirements. It has not been arranged how interpretation differences between the taxpayer and the tax administrations should be resolved.

**Attention points for the preparation and filing of the CbCR**

First, there are some tips on the data to be provided:

- Be consistent with data used for all Constituent Entities. Be consistent over time.
- Inconsistencies cannot always be avoided. Make sure you can explain them when they happen.
- Try to avoid misinterpretations by providing clear definitions, descriptions, and explanations when filing the CbCR.
- Bear in mind that the CbCR and corporate tax returns are reconciled.

On the process to prepare and file a CbCR:

- Start on time with the filing preparation.
- Engage internal stakeholders such as finance and legal at an early stage – you will need information from them!
- Seek support from external professionals.
- Do a dry run before the actual filing of the CbCR.
- Manage expectations at the tax authorities.
Afterword

Thank you for reading this book. We trust that it has helped you better understand the rules for transfer pricing and its practice. You should now be ready to tackle day-to-day transfer pricing issues wherever they might arise!

If you have suggestions for improving what is written here, please don’t hesitate to send us an email: info@transferpricingasia.com.

And of course, please do check our website www.transferpricingasia.com from time to time to keep up with any future courses or training material that we produce!